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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

No. 1078

EDWIN J. HERWICH, on Behalf of All the Stockholders of National American Life Insurance Company,
Petitioner,

vs.

ROBERT E. WILDER and NATIONAL AMERICAN LIFE INSURANCE COMPANY, a Louisiana Corporation,
Respondents.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals for the Fifth Circuit

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IN THE

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OCTOBER TERM, 1970

No.

EDWIN J. HERPICH, on Behalf of All the Stockholders of National American Life Insurance Company,
Petitioner,

vs.

ROBERT E. WILDER and NATIONAL AMERICAN LIFE INSURANCE COMPANY, a Louisiana Corporation,
Respondents.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals for the Fifth Circuit

Petitioner prays that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above case on the 14th day of July, 1970.

OPINIONS BELOW

Neither the two District Court opinions below of Judge Frank Johnson, Jr. of the Middle District of Alabama of October 24, 1968 (p. A-3, *infra*), and January 14, 1969 (p. A-7, *infra*), nor the three opinions of July 14, 1970 of the Court of Appeals for the Fifth Circuit in this and two companion appeals (pages A-16, A-19 and A-64,

infra),[1] have been officially reported. Two District Court orders entered by Judge H. H. Grooms of the Northern District of Alabama in related litigation have not been officially reported and are reproduced *infra* at pages A 80 and A 82,[2] because of their relevance to this appeal.

JURISDICTION

The judgment below of the Court of Appeals for the Fifth Circuit was entered on July 14, 1970. On October 8, 1970, Mr. Justice Black extended the time for filing a Petition for Writ of Certiorari hereto to and including December 11, 1970. The jurisdiction of this Court is invoked under 28 U. S. C. 1254(1).

QUESTIONS PRESENTED

1. Does a corporation have a federal right of action, which may be asserted for its benefit in a derivative action brought by one of its stockholders, to recover from its former president a "premium" of more than one million dollars above market value allegedly paid the former president for his shares of stock (in the corporation and in its parent) where it is claimed that the former president engaged in a fraudulent scheme and in acts, practices and business dealings which operated as an equitable fraud upon the corporation in connection with the former president's sale of securities in violation of clauses (1)

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[1] Unofficially reported as **Herpich v. Wilder**, CCH Fed. Sec. L. Rep., ¶ 92,715 (5th Cir. July 14, 1970); **Herpich v. Wallace**, CCH Fed. Sec. L. Rep., ¶ 92,714 (5th Cir. July 14, 1970); and **Shell v. Hensley**, CCH Fed. Sec. L. Rep., ¶ 92,713 (5th Cir. July 14, 1970).

[2] Unofficially reported as **Hensley v. Shell**, CCH Fed. Sec. L. Rep., ¶ 92,289 (N. D. Ala. October 15, 1968); and **Hensley v. Love**, CCH Fed. Sec. L. Rep., ¶ 92,370 (N. D. Ala. March 12, 1969).

and (3) of SEC Rule 10b-5[3] and Section 10(b) of the Securities Act of 1934, 15 U. S. C., § 78j(b), in that the former president was approached by someone who desired to acquire control of the corporation and its assets, the former president could have cast the proposed transaction as a merger or as a sale of the corporation's assets or as a tender offer to all stockholders (on a *pro rata* basis or otherwise), but that the former president, in violation of his duty to the corporation, instead cast the transaction as one for his own personal benefit, sold his own shares of stock at a "premium" more than one million dollars above their market value, and failed to account to the corporation for the premium?

2. Do the minority stockholders of a corporation have a direct (as distinguished from derivative) federal right of action for damages against the former president of the corporation where it is claimed that the former president engaged in a fraudulent scheme and in acts, practices and business dealings which operated as an equitable fraud upon the minority stockholders in connection with the former president's sale of securities in violation of clauses (1) and (3) of SEC Rule 10b-5 and Section 10(b) of the Securities Act of 1934, 15 U. S. C., § 78j(b), in that the former president was approached by someone who desired to acquire control of the corporation and its assets, the former president could have cast the proposed transaction as a merger or as a sale of the corporation's assets

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[3] Rule 10b-5 provides, in part:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, . . .

"(1) To employ any device, scheme, or artifice to defraud, . . .

"(3) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

or as a tender offer to all stockholders (on a *pro rata* basis or otherwise), but that the former president, in violation of his duty to minority stockholders, instead cast the proposed transaction as one for his own personal benefit, sold his own shares of stock at a "premium" more than one million dollars in excess of their market value, failed to insist that all the stockholders be made same offer, and failed to account for the premium?

STATUTES AND REGULATIONS INVOLVED

Relevant portions of Sections 10(b) and 27 of the Securities Exchange Act of 1934 (15 U. S. C., §§ 78j(b) and 78v) and SEC Rule 10b-5 (17 C. F. R., § 240.10b-5) are reproduced *infra* at pages A 1-2.

STATEMENT OF THE CASE

This petition seeks review of the order and judgment of the Court of Appeals in a civil action brought by a stockholder, seeking damages for the use and benefit of his corporation and also damages in his own right and for the use and benefit of other minority stockholders similarly situated.

The plaintiff's complaint in the District Court alleged that the defendant, Robert E. Wilder, formerly President, Chairman of the Board and Chief Executive Officer of National American Life Insurance Company (herein "National American"), engaged in a fraudulent scheme and in acts, practices and courses of business which operated as a fraud upon National American in connection with a sale by Wilder of securities. The complaint alleges that Wilder was approached by a group interested in acquiring control of National American and its assets, that Wilder could have cast the transaction as a merger of National American with another corporation or as a sale

of National American's assets or as a tender offer to all stockholders (on a *pro rata* basis or otherwise), but instead, in violation of his fiduciary duty, cast the transaction as a sale of his personally owned stock in National American and in First Colonial Corporation of America (which in turn owned a substantial block of stock of National American) at a premium more than one million dollars in excess of the then market value of Wilder's stock. The complaint alleges that Wilder agreed to resign and assist in electing nominees of the purchaser to office in National American, so as to enable the purchaser to obtain control of its assets. The complaint alleges that Wilder and the purchaser agreed that National American would be caused to pay part of the "premium" to Wilder. Plaintiff asserts that Wilder thereby engaged in a fraudulent scheme, acts, practices and courses of business dealings which operated as an equitable fraud upon National American and upon its minority stockholders, in that Wilder, in violation of his fiduciary duty, and by the use of the mails and means of interstate commerce, and in connection with the sale of his stock, converted to his own benefit an opportunity available to the corporation and all its stockholders.

In the two District Court opinions below, Judge Johnson stated that the Complaint and Amended Complaint sufficiently alleged a "fraud" and a sale of securities by Wilder but ruled that a federal cause of action under Rule 10b-5 was not stated because he said the required "connection" between the fraud and sale was not alleged and because the plaintiff and National American were not privy to the sale of securities by Wilder. Accordingly, the District Court dismissed the complaint for lack of jurisdiction, diversity jurisdiction being absent.

In its opinion below, the Court of Appeals affirmed so much of the District Court judgment as dismissed the individual and class claims, but reversed so much of the

District Court judgment as dismissed the derivative claims asserted under Rule 10b-5 for the use and benefit of National American for such of its damages as might be proved to have been sustained directly and as a proximate consequence of the alleged fraudulent scheme to cause National American to pay part of the excessive purchase price to Wilder by the contrivance and device of a subsequent merger of National American with an affiliate and successor in interest to the purchaser of Wilder's stock, the merger being considered a statutory "purchase" or "sale" of securities. See **SEC v. National Securities, Inc.**, 393 U. S. 453 (1969). The opinion of the Court of Appeals is somewhat unclear. That opinion states that Rule 10b-5 prohibits frauds only upon the "purchaser" or "seller" of securities and suggests that National American's claim for the premium, as distinguished from its claims for other damages allegedly sustained by it in connection with the merger scheme (1) arises solely from state law or (2) is cognizable under Rule 10b-5 only if shown to have been an integral part of a scheme to merge National American.

REASONS FOR GRANTING THE WRIT

It is respectfully submitted that this Court should grant certiorari in order to review and revise the decision of the Court of Appeals below. The decision below involves pervasive and extremely important questions with regard to the scope of duties imposed by the Securities Exchange Act of 1934 and Rule 10b-5 upon corporate officers, directors, and controlling stockholders with regard to their corporation and its stockholders. The decision below erroneously limits protections afforded investors and the public by federal law and regulations, and is in conflict with decisions of other circuits. These important questions and the conflicts between the circuits should be resolved by this Court.

I. The Decision Below Is of Great Importance and Improperly Limits Protection Afforded Investors and the Public by Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C., § 78j(b).

The scope of the duty owed to a corporation and to minority stockholders by the officers, directors and controlling stockholders of the corporation is a troublesome problem which has been the subject of a great deal of litigation and legal commentary. It is an extremely important question, affecting as it does not only the rights, duties and conduct of corporate fiduciaries but also insofar as it greatly affects the rights of the minority stockholders and the value of stock held by minority stockholders. Inasmuch as our American economy is largely based upon the willingness of public investors to invest in stock, it is extremely important that the standards of conduct imposed by federal securities laws and regulations be clarified and that the confusion, legal fog and uncertainties which have arisen in a number of lower court decisions, including the decision below and an early decision of the Second Circuit in **Birnbaum v. Newport Steel Corp.**, 193 F. 2d 461 (2d Cir.), **cert. denied**, 343 U. S. 956 (1952) be finally dispelled by this Court.

In a recent opinion, this Court commented upon the "complications" and "standing" problems which have vexed the lower court, citing an article by Lowenfels, entitled "The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5," 54 **Virginia Law Review**, 268 (1968), in footnote 9 of its opinion in **SEC v. National Securities, Inc.**, 393 U. S. 453 (1969).

We respectfully submit that this Court should grant certiorari in order to resolve once and for all whether Rule 10b-5 prohibits fraud "upon any person" in connection with the purchase or sale of securities, as the Rule ex-

pressly provides, rather than being limited to frauds committed upon "purchasers" or upon "sellers" of securities.

The opinion of the Court of Appeals for the Fifth Circuit, in a landmark decision in **Shell v. Hensley**, *infra* at p. A-64, and the recent *en banc* decision of the Court of Appeals for the Second Circuit in **Schoenbaum v. Firstbrook**, 405 F. 2d 215 (2d Cir. 1968), **cert. denied**, 395 U. S. 906 (1969) appear to recognize that "equitable fraud" as defined by this Court in **Moore v. Crawford**, 130 U. S. 122 at 128 (1889) is prohibited by Rule 10b-5. See, Comment, "**Schoenbaum v. Firstbrook**: The 'New Fraud' Expands Federal Corporation Law," 55 **Virginia Law Review** 1403 (1969), Patrick, "Rule 10b-5, Equitable Fraud and **Schoenbaum v. Firstbrook**, Another Step in the Continuing Development of Federal Corporation Law," 21 Alabama Law Review 457 (1969). In doing so, the two Courts of Appeal have merely applied to the Securities Exchange Act of 1934 the holding of this Court with regard to a similar provision in the Investment Advisers Act of 1940, 15 U. S. C. § 80b-1 et seq. in **SEC v. Capital Gains Research Bureau, Inc.**, 374 U. S. 180 at 193, 195 (1963):

> "Fraud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element.
>
> . . . .
>
> "Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively but flexibly to effectuate its remedial purposes.
>
> "Thus, even if we were to agree with the courts below that Congress had intended, in effect, to codify the common law fraud in the Investment Advisers Act of 1940, it would be logical to conclude that Congress codified the common law 'remedially' as the

courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not 'technically' as it had traditionally been applied in damage suits between parties to arms length transactions involving land and ordinary chattels."

Having recognized that a fraud is sufficiently alleged, the District Court and Court of Appeals below held, nonetheless, that a federal cause of action under Rule 10b-5 could not be asserted unless the plaintiff was either a "purchaser" or "seller" or privy to the purchaser or seller in a securities transaction. We respectfully submit that Section 10(b) itself, which authorizes the Commission to adopt regulations for the protection of the public interest and for the protection of investors, and the language of Rule 10b-5 itself, which prohibits fraud "upon any person" in connection with a purchase or sale of securities militate against such a narrow construction of the statute and rule.

Applying the "purchaser-seller" doctrine, the court below held that petitioner and similarly situated shareholders did not have a direct (as distinguished from a derivative) right of action under Rule 10b-5 to recover the "premium" which Wilder fraudulently appropriated to himself by denying to minority shareholders equal opportunity to participate in the sale of control of their corporation.

This Court has recognized that a violation of the Securities Exchange Act of 1934 may give a shareholder both a derivative and a direct cause of action. In **J. I. Case Co. v. Borak**, 377 U. S. 426 (1964), this Court stated:

> "While the respondent contends that his Count II claim is not a derivative one, we need not embrace that view, for we believe that a right of action exists as to both derivative and direct causes."

This Court's conclusion in the **Bennett** case affirmed that of the Court of Appeals for the Seventh Circuit, at 317 F. 2d 920 (1963), in the same matter where that court stated:

> "We think the trial court failed to recognize the presumption that the same allegations of fact might support either a derivative suit or an individual cause of action by shareholders. We think Count I of the complaint adequately states a cause of action for the violation of rights individual to the [non-]stockholders."

In a recent case of control over minority under state law, **Jones v. H. F. Ahmanson & Co.**, 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P. 2d 464 (1969), the court recognized the direct, individual right of the minority shareholders to assert a cause of action for the fraud perpetrated upon them by the controlling stockholders. The Supreme Court of California held in that case that minority stockholders had a right of action for the diminished market value of their stock resulting from "self-dealing" transfer of their own stock to a holding company, where the result was that there was a market in the holding company stock but no market in the stock of the savings and loan association. The Supreme Court of California stated:

> "Majority shareholders, either singularly or acting in concert to accomplish a joint purpose, have a fiduciary responsibility to the minority and to the corporation to use their ability to control the corporation in a fair, just, and equitable manner. Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately." 460 P. 2d 464 at 471.

The fact that the individual stockholders have not sold their stock in the corporation should not prevent them from asserting their claim when they have been defrauded in connection with a sale of securities. See **Blackwell v. Reynolds & Co.**, 267 F. Supp. 215, 18 Is N. Y. 1965), and **Oppor v. Hancock Securities Corp.**, 367 F. 2d 157 (2d Cir. 1966), where the defendant's fraud prevented the plaintiff from selling his stock advantageously.

The holding by the court below that petitioner and similarly situated shareholders cannot recover under Rule 10b-5 for a fraud upon them in connection with a purchase or sale of securities because petitioner and similarly situated stockholders are not "purchasers" or "sellers" imposes a mechanical rule of thumb as to standing which has no basis in Rule 10b-5 itself. Plaintiffs submit that the imposition of such a mechanical test is out of keeping with the purposes of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5, both of which were developed to provide flexible protection to investors. The "purchaser-seller" requirement has drawn critical fire in a number of law review articles, see, e.g., Lowenfels, "The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5," 54 **Virginia Law Review** 958 (1968); Schwartz, "The Rule of Control and the 1934 Act: New Directions for Federal Corporation Law," 3 **New York Law Forum** 674 (1957); Comment, "The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5," 56 **Georgetown Law Journal** 1177 (1968); Comment, "The Purchaser-Seller Limitation to SEC Rule 10b-5," 53 **Cornell Law Quarterly** 684 (1968); Payne, Recent Case Note: **Kahan v. Rosenstiel**, 1 **Cumberland Samford Law Review** 375 (1970).

In a number of briefs the Securities Exchange Commission has expressed the view that the "purchaser" or "seller" requirement imposed by **Birnbaum** was errone-

ous. See, e. g., Brief for SEC as Amicus Curiae at 5-9, **A. T. Brod v. Perlow**, 375 F. 2d 393 (2d Cir. 1967); Brief for SEC as Amicus Curiae at 5-6, **Vine v. Beneficial Finance Co.**, 374 F. 2d 627 (2d Cir. 1967); Brief for SEC as Amicus Curiae at 8, **Pacific Ins. Co. v. Blot**, 267 F. Supp. 956 (S. D. N. Y. 1967).

Petitioner respectfully submits that the appropriate occasion has arrived for this Court to rule that the purchaser-seller requirement of **Birnbaum** is no longer good law.

Even if the "purchaser seller" requirement of **Birnbaum** is not finally and totally discarded, the court below misconstrued Rule 10b-5 in not holding that under the doctrine of "equitable fraud" petitioner has standing, both individually and derivatively, to recover the premium received by Wilder.

Petitioner's Complaint alleges that Wilder conspired and agreed with the purchasers of control that he would "convert" to his own benefit a corporate opportunity to engage in a securities transaction, and that he would not account. Wilder chose to cast the transaction in a manner which would benefit him, rather than casting it in a manner which would benefit the corporation and all its stockholders, e. g., through a merger, tender offer (pro rata or other wise) or sale of assets. As this Court held in **Southern Pac. Co. v. Bogert**, 250 U. S. 482 (1919):

> "The wrong consists in the failure to share with them, the minority, the proceeds of the common property . . . and equity enforces the right by declaring the trust on which Southern Pacific holds it and ordering distribution or compensation."

In the analogous situation at common law, a person who converts someone else's property and sells it is "deemed"

to have acted as agent for the owner. The owner may sue "in assumpsit" and the wrongdoer is estopped to deny that the wrongdoer acted as agent for the owner in selling the converted property. See, e. g., **Martin v. Rutledge**, 94 Vt. 258, 110 Atl. 883 (1922); **Capital Garage Co. v. Powell**, 90 Vt. 277, 118 Atl. 222 (1920). As a fiduciary, Wilder was acting for his *cestuis que trust*—the corporation and its minority stockholders—so that Petitioner and the corporation should be deemed "sellers," with the right to require Wilder to account. As the Court of Appeals for the Second Circuit said in **A. T. Brod v. Perlow**, 375 F. 2d 393 (2d Cir. 1967):

> "We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." 373 F. 2d at 396-97.

The Securities Exchange Act of 1934 manifests throughout a concern for the question of corporate control. Petitioner respectfully believes this Court should take jurisdiction of this cause to consider the important question raised as to the duty of a controlling stockholder with respect to his corporation and to minority stockholders in the transfer of corporate control.

II. The Decision Creates Unnecessary Ambiguities in an Important Area of the Law and Appears to Be in Conflict With Decisions of Other Circuits.

The decision below of the Court of Appeals finds that National American Life Insurance Company is a "purchaser" or "seller" within the statutory meaning of those terms with respect to a resolution of the Board of Di-

rectors of National American Life Insurance Company concerning the merger of National American Life Insurance Company with a company affiliated with the purchaser of Wilder's stock, National Securities, Inc., and its successor in interest with respect to the stock purchased from Wilder. This Court has held in **SEC v. National Securities, Inc.**, 393 U. S. 453 (1969) that a merger is a "purchase" or "sale" within the meaning of Securities Exchange Act of 1934. In accordance with its finding that National American Life Insurance Company was a "purchaser" or "seller", the Court below reversed and remanded, holding that plaintiffs had stated a Rule 10b-5 action for damages derivatively on behalf of National American:

> "... provided, of course, that the corporations can show that it was directly and proximately injured by the defendants' fraud or deceit in connection with the resolution to merge."

The Court below further stated:

> "On remand, therefore, it must be determined whether National American, as 'purchaser' or 'seller' has been proximately injured by acts amounting to the employment by defendants of a scheme to defraud the corporation in violation of the rule."

The decision below is ambiguous as to whether plaintiffs must show, in order to prove their claim under Rule 10b-5, that the corporation was damaged as a result of the resolution to merge. If the decision were so construed, it would be in conflict with **Errion v. Connell**, 236 F. 2d 447 (9th Cir. 1956), **Crane v. Westinghouse Air Brake Co.**, 419 F. 2d 787 (2d Cir. 1970), and **Vine v. Beneficial Finance Co.**, 374 F. 2d 627 (2d Cir. 1967). These cases have held that a plaintiff need not show that he has been injured by his purchase or sale of securities, so

long as he can show that he suffered damages in the overall scheme.

The Court of Appeals for the Ninth Circuit has held that there need not be a fraudulent representation concerning securities, so long as there is fraud "in connection with a purchase or sale of securities," in **Errion v. Connell**, 236 F. 2d 447 (9th Cir. 1956). There an eighty year old widow was induced to sell securities and to use the cash proceeds and other securities to purchase worth less tidelands represented to be oyster beds worth $1,200 per acre. In describing the representations made, the Court of Appeals said:

> "... the most important of which was the alleged fact that the Port of Coos Bay, Oregon, was planning to condemn the Oregon lands and would do so within a year, and that the land was reasonably worth $1,200 per acre; but that in order to establish such a valuation, Mr. Errion was inducing several people to buy the land there so that there would be sales within the area which would support such a valuation."
>
> • • • • • • •
>
> "We are of the opinion that the Act of 1934 was designed to cut out 'sharp practices' and fraudulent schemes **involving securities**, and the fact that there may be a co-mingling of securities with non-securities in the scheme does not oust the United States District Court of jurisdiction." [Emphasis supplied.]

In **Errion** the Court did not require the plaintiff to prove she had been deceived concerning the value of the securities sold for cash. It required only that she show damages in a fraudulent scheme "**involving securities**."

Vine v. Beneficial Finance Co., 374 F. 2d 627 (2d Cir. 1967) involved the allegedly fraudulent sale of controlling stock, which the Court of Appeals found to violate Rule

10b-5 based on facts striking analogous to those presented in the present action. Plaintiff in that case alleged that the Class "B" stockholders of Crown Finance Co., Inc., ("Crown") conspired with a prospective purchaser, Beneficial Finance Co., to "shape the transaction in such a way" that Class "B" stockholders would be paid about $700,000 for their shares plus about $200,000 in benefits under employment and consulting agreements. The alleged fraudulent scheme involved three steps: (1) a purchase by Beneficial of the Class "B" stock from the directors of Crown, (2) a public offer or tender by Beneficial to the holders of Class "A" stock to acquire 95% of the total outstanding shares of Crown, and (3) a short form merger of Crown into a subsidiary of Beneficial, which resulted in the forcing out of the remaining Class "A" shareholders, their assent being unnecessary. Plaintiff alleged that there was deceit and a failure to disclose material facts to the Class "A" stockholders in connection with the tender offer. Defendants argued that Plaintiff who had **not** tendered his stock, could not complain of any deceit practiced on other Class "A" stockholders. The Court of Appeals held that Plaintiff has standing to complain of the deception practiced on other Class "A" stockholders, since this deception was part of a scheme which allegedly damaged Plaintiff, and that he need not be a "seller" of his stock, because his rights were frozen and he could be required to "sell" his stock by the device of a short form merger.

The Court further held that the plaintiff did not have to show that he was damaged by the offer of an unfair price of $3.29 per share to him in the short-form merger, when he claimed that he and all class "A" stockholders had been injured by the fraudulent sale by class "B" stockholders, of control of the corporation to Beneficial Finance Co., at a premium.

In the very recent case of **Crane v. Westinghouse Air Brake Co.**, 419 F. 2d 787 (2d Cir. 1970), the Court held that the plaintiff, a defeated tender offeror who subsequently was forced to dispose, for anti trust reasons, of securities purchased preparatory to the tender offer, was a "seller" under Rule 10b-5 because of the subsequent sale of such securities. The plaintiff's tender offer had failed because a trade competitor, who subsequently merged with the target corporation, had manipulated the price of the stock on the last day of plaintiff's tender offer. The plaintiff complained of the trade competitor's purchases of stock from the public, transactions in which the plaintiff had not been a party, either as purchaser or seller. The "sale" which the Court of Appeals, following its earlier decision in **Vine v. Beneficial Finance Co.**, 374 F. 2d 627 (2d Cir. 1967), held gave plaintiff standing to complain of the stock manipulations of its trade competitor was its later sale of securities purchased preparatory to its take over bid. Plaintiff was fortunate enough to dispose of such securities at a profit of several million dollars. Plaintiff could scarcely have been said to have been injured **qua** seller or **qua** purchaser of securities. Its injury, caused by the market manipulations of its trade competitor, was the failure of its tender offer. Yet the Court found that the plaintiff had standing under Rule 10b-5 to complain of that injury.

Petitioner believes that, under the foregoing decisions in **Errion v. Connell**, *supra*, **Vine v. Beneficial Finance Co.**, *supra*, and **Crane v. Westinghouse Air Brake Co.**, *supra*, Petitioner should not be required, on trial of this cause, to show that National American Life Insurance Company had been directly and proximately injured by fraud directly involving the resolution to merge. The burden, both in trial and discovery, placed upon Petitioner by the added requirement imposed by the opinion below,

if read to require that the plaintiff must demonstrate injury caused by and directly related to the resolution to merge, denies to Petitioner the full protection intended by the promulgation of Rule 10b-5.

Even if the "purchaser-seller" rule is to be applied by federal courts in determining the scope of Rule 10b-5, the conflicts between circuits as to its application should be resolved by this Court so that investors, the financial community and the courts may have the benefit of a uniform rule.

III. This Court Should Grant Certiorari Herein and in Superintendent of Insurance as Liquidator for Manhattan Casualty Co. v. Bankers Life and Casualty Co., ... F. 2d ..., CCH Fed. Sec. L. Rep., ¶ 92,724 (2d Cir. July 22, 1970).

Petitioner is informed that a Petition for Certiorari will shortly be filed, or may have already been filed, in the case of **Superintendent of Insurance as Liquidator for Manhattan Casualty Co. v. Bankers Life and Casualty Co.**, ... F. 2d ..., CCH Fed. Sec. L. Rep., ¶ 92,724 (2d Cir. July 22, 1970). Superintendent of Insurance as Liquidator of Manhattan Casualty Company also involves a sale of control and raises important issues with respect to the concept of "equitable fraud," whether the fraud or deception complained of must relate to the securities purchased or sold, and the extent of the "purchaser-seller" requirement in an action under Rule 10b-5. Manhattan Casualty was a "seller" of securities in that it sold on the open market from its own portfolio, U. S. Government Bonds, apparently at a fair price, at the time of the closing of the sale of control. Manhattan Casualty was then fraudulently caused to make an unsecured "loan" of the proceeds realized from the sale of government bonds to the purchaser of control, thereby depleting its assets. The

purchaser of control failed to account to the corporation for its funds. The Court of Appeals for the Second Circuit held that there was no Federal Right of Action under Rule 10b-5, applying the "purchaser-seller" rule and holding that there was no "deception" of the corporation with respect to the sale of its U. S. Government Bonds, notwithstanding the plaintiffs' allegation that the application of the proceeds of the sale and plaintiffs' claim that the sale, loan, and failure to account were all pursuant to and an integral part of scheme to defraud.

The important issues raised in the **Superintendent of Insurance as Liquidator for Manhattan Casualty Co. v. Bankers Life and Casualty Co.** Petition for Certiorari are related to the issues presented in this petition. Petitioner respectfully submits that this Court should grant Writ of Certiorari in both cases.

CONCLUSION

For the reasons given hereinabove, this Court should issue its Writ of Certiorari to the Court of Appeals for the Fifth Circuit to review that Court's decision in this case.

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APPENDIX I

Pertinent Statutes and Regulations

§ 10(b), Securities Exchange Act of 1934, 15 U. S. C., § 78j:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> * * * * * * *
>
> (b) The use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

§ 27, Securities Exchange Act of 1934, 15 U. S. C., § 78aa (in pertinent part):

> The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations

thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

Securities and Exchange Commission Rule 10b-5, promulgated pursuant to the Securities Exchange Act of 1934, 17 C. F. R., § 240.10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

APPENDIX II

In the United States District Court for the Middle District of Alabama, Northern Division

Edwin J. Herpich, on Behalf of All the Stockholders of National American Life Insurance Company, Plaintiff, vs. Robert E. Wilder; and National American Life Insurance Company, a Louisiana Corporation, Defendants.	Civil Action No. 2747-N.

Order

(Filed Oct. 24, 1968)

This cause is now submitted upon defendant Wilder's motion to dismiss. Three grounds for the motion are alleged: (1) failure to state a federal cause of action; (2) failure to make a demand of the directors and/or shareholders as required by Rule 23; and (3) failure to join the directors of the corporation as necessary parties.

Plaintiff's sole basis for federal jurisdiction is Section 27 of the Securities Exchange Act of 1934 (15 U. S. C., § 78aa). As there is no diversity, failure to state a federal cause of action deprives this Court of jurisdiction.

Plaintiff alleges numerous transactions by defendant Wilder which allegedly have damaged defendant corpo-

ration and/or the shareholders as a class. Numerous violations of Alabama law are alleged. The issue here is whether a violation of Rule 10b-5 has been adequately alleged. Simply stated, that issue is whether plaintiff has alleged fraud in connection with the purchase or sale of securities. This Court concludes that he has not.

Plaintiff seems to place principal reliance on the allegation that defendant Wilder sold a controlling block of shares in the corporation at a premium price without making the offer available, *i. e.*, disclosing it, to plaintiff. The difficulty with this allegation is that, while plaintiff has alleged a sale of securities and a fraud, he has not shown the required "connection." It is not alleged that plaintiff failed to disclose any relevant information to the buyer of his shares. Indeed, plaintiff suggests the buyer is most pleased. As to the corporation and the shareholders, defendant Wilder does not, on these facts, stand in the relationship of a seller. And, his status as a seller does not impose any duty upon him to disclose the transaction to these unrelated parties. Of course, Wilder may well have been under a duty to disclose the transaction to plaintiff, but if he was, that duty arose from his status as an insider and arises from state law. See, *e. g.*, **Perlman v. Feldmann**, 219 F. 2d 173 (2nd Cir. 1955). Although the broad statement in **Birnbaum v. Newport Steel Corp.**, 193 F. 2d 461 (2nd Cir. 1952), that a corporate mismanagement is not within the purview of Rule 10b-5 has been increasingly criticized, this Court is not aware that the narrow holding of the case has been questioned. **Birnbaum** holds that 10b-5 does not impose a duty to disclose to those who are not parties to the transaction.

Although it is not completely clear from the order, Judge Grooms' decision in **Hensley v. Shell**, Civil No. 63-641, N. D. Ala., Oct. 15, 1968, may be to the contrary. If it is, this Court respectfully disagrees. However, it

should be noted that Paragraph IV(1)(e) of the complaint in that case clearly alleges a 10b-5 action when it states that the defendant caused the corporation to purchase securities at an exorbitant price. **Hooper v. Mountain States Securities Corp.**, 282 F. 2d 195 (5th Cir. 1960); **Huckle v. Roto American Corp.**, 339 F. 2d 24 (2nd Cir. 1964). That allegation would certainly support denial of the motion to dismiss.

Plaintiff also relies on the allegation that defendant caused the corporation to guarantee the purchase of another corporation's purchase of certain bank stocks. Contrary to the suggestion in plaintiff's brief of October 22, it is not apparent from the complaint that the guaranty transaction is related to the above mentioned sale of control. In any event, the issue concerning the guaranty is whether it is tantamount to a purchase. At best it is a conditional purchase, since the corporation is only obligated to purchase if the primary purchaser defaults. This Court concludes that a conditional purchaser such as this does not have an action for damages under Rule 10b-5 absent an allegation that the condition has occurred. A conditional purchaser might be entitled to injunctive relief, see **Mutual Shares Corp. v. Genesco, Inc.**, 334 F. 2d 540, 546-47 (2nd Cir. 1967), but plaintiff here seeks only damages.

Because it is possible that out of this maze of wheeling and dealing a complaint might be drafted that states a federal cause of action, this one will be dismissed without prejudice to its being filed in substantially amended form and, of course, without prejudice to any actions plaintiff might bring in an appropriate state court. Concerning the possibility of amendment, however, it is only fair to note that this Court considers the present complaint an attempt to bring a large state law derivative action, absent diversity, into federal court on a poor 10b-5 theory. Even

if this Court had found a 10b-5 action in this case, the guides to the exercise of pendent jurisdiction set forth in **United Mine Workers of America v. Gibbs**, 383 U. S. 715, 722-27, virtually demand that the state law claims be dismissed.

Accordingly, it is the Order, Judgment and Decree of this Court that the motion of defendant Wilder to dismiss the complaint for failure to state a federal cause of action be and the same is hereby granted. It is further Ordered that the complaint in this action be and the same is hereby dismissed, without prejudice.

It is further Ordered that the costs incurred in this proceeding be and the same are hereby taxed against the plaintiff.

Done, this the 24th day of October, 1968.

Frank M. Johnson, Jr.
United States District Judge

APPENDIX III

In the United States District Court for the
Middle District of Alabama
Northern Division

Edwin J. Herpich, on Behalf of Himself and All Other Stockholders (Other Than Defendant Wilder and Persons in Conspiracy With Him) of National American Life Insurance Company, Plaintiff, vs. Robert E. Wilder; and National American Life Insurance Company, a Louisiana Corporation, Defendants.	Civil Action No. 2747-N

Order

(Filed Jan. 14, 1969)

This cause is now submitted on defendant Wilder's motion to dismiss plaintiff's amended complaint. Plaintiff seeks to recover for violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C., Sec. 78j(b), of the Investment Company Act of 1940, 15 U. S. C., Secs. 80a-1, et seq., and of Alabama law. Plaintiff's original complaint was dismissed with leave to amend for failure to state a federal cause of action by an order of this Court filed October 24, 1968. Although the amended complaint adds the count under the Investment Company

Act and makes other changes in the original, it also fails to state a federal cause of action.

Plaintiff Herpich is a stockholder in National American Life Insurance Company and seeks to recover derivatively on behalf of that corporation and representatively on behalf of its stockholders. With respect to the count under the Investment Company Act, the amended complaint alleges that defendant Wilder was a "controlling person" of both National American and First Colonial Corporation. It is also alleged that Wilder caused First Colonial to fail to register as an investment company as required by the Act. Wilder also allegedly caused First Colonial to control National American and caused National American to make inadequately secured loans to First Colonial and to enter into purchases and sales of stock with First Colonial.

There is no longer much doubt that in a proper case a court will imply civil liability for violation of the Investment Company Act. See **Brown v. Bullock**, 294 F. 2d 415 (2nd Cir. 1961); **Esplin v. Hirschi**, 402 F. 2d 94 (10th Cir. 1968). See also **Greater Iowa Corp. v. McLendon**, 378 F. 2d 783 (8th Cir. 1967), which seriously questions the only authority to the contrary, **Brouk v. Managed Funds, Inc.**, 286 F. 2d 901 (6th Cir. 1961). This, however, is not such a case.

It is a corollary of the doctrine of implied liability in tort for violation of a criminal statute that the plaintiff must be within the class the statute was designed to protect. See, *e. g.*, Restatement (Second), Torts, Section 286. Here, it is not alleged that the plaintiff or National American are stockholders in the alleged investment company. The only injuries complained of are to a "controlled" corporation and only a derivative recovery in favor of National American is sought.

Plaintiff suggests that Wilder violated several provisions of the Investment Company Act. However, plaintiff is clearly not within the class that some of these provisions were designed to protect. Section 17 prohibits various transactions of certain affiliated persons and underwriters. Section 36, 15 U. S. C., Sec. 80a-37, authorizes the Commission to seek injunctions against gross misconduct and abuse of trust. Even if the complaint adequately alleged violations of these statutes, which it does not, it seems clear from the terms of the provisions that they were designed only for the protection of the shareholders of an investment company.

Assuming, arguendo, that First Colonial was required to register as an investment company, the complaint can be read as alleging a violation of Section 7(a) of the Act, which provides in pertinent part:

> "Section 80a-7. Transactions by unregistered investment companies.
>
> (a) No investment company organized or otherwise created under the laws of the United States or of a State and having a board of directors, unless registered under Section 80a-8 of this title, shall directly or indirectly
>
> * * * * * * *
>
> (5) control any company which is engaged in any business in interstate commerce."

It is adequately alleged that National American was controlled by First Colonial. Since Section 43, 15 U. S. C., Sec. 80a-47, prohibits procuring violations of the subchapter, it is also adequately alleged that defendant Wilder caused First Colonial to fail to register.

This Court cannot conclude, however, that Section 7 was designed to protect the class of which plaintiff's corporation is a member. In the only case in which a similar issue was squarely faced, **Greater Iowa Corp. v. Mc-**

Lendon, *supra*, the same conclusion was reached. There defendants were disenchanted shareholders of plaintiff corporation who formed a voting trust in an attempt to change the management. Plaintiff alleged that this trust constituted an investment company and attempted to force it to register. But Judge Gibson, speaking for the Eighth Circuit, stated:

> "A reading of the 'Findings and Declarations of Policy' at 15 U. S. C., Sec. 80a 1 indicates that the Act was primarily aimed at the protection of individuals who purchase the security issued by the investment company. Repeated reference is made to the security holder and to the investor, without mention of the class of which plaintiffs are members. The Act provides for disclosure of pertinent facts to the shareholders, fair management, investment of assets for the benefit of shareholders rather than management, sound financing of the company; all generally or specifically designed for the protection of the investing public.
>
> Plaintiffs have no legal connection with defendants' operation. They are not competitors being injured by illegal practices. They are not investors being deprived of the protection afforded by the Act. They are not privies or beneficiaries of any contract with defendants. Plaintiffs are merely fellow shareholders and the issuer of the securities held by this alleged investment company. We see no basis under this Act that the issuer company can oversee the trading of its securities or object to the method in which its shares are acquired or the persons who acquire them." **Greater Iowa Corp. v. McLendon**, *supra* at 793-94.

Plaintiff seeks to distinguish **Greater Iowa Corp.** on the ground that here the situation involves contractual rela-

tions between a controlled corporation and a violator of the statute. Plaintiff argues in effect that Section 7 in terms confers standing upon a controlled corporation when it prohibits control by an **unregistered** company. But since the Act contains no restrictions as such on control of companies by **registered** investment companies, it is difficult to conclude that it manifests an intent to protect controlled or dominated companies. To the contrary, it seems plain that the purpose of the disabilities set forth in Section 7 is to propel investment companies into registering and thus to subject them to the regulation contemplated by the Act.

The other substantial contention plaintiff asserts involves the claim that defendant Wilder violated Section 10(b) of the 1934 Act in connection with his sale of a controlling bloc of shares in National American. The previous dismissal order rejected the bald claim that the sale of a controlling bloc of shares without sharing the profits or disclosing the offer to the other stockholders violates federal law. That holding was based on the failure to allege any "connection" between the alleged fraud and the sale of securities as required by Rule 10b-5. **Birnbaum v. Newport Steel Corp.**, 193 F. 2d 461 (2nd Cir. 1952) was cited for the narrow holding that there is no duty of disclosure to those not rather directly interested in the purchase or sale as a puchase or sale. For purposes of clarity, this Court would repeat that it did not rely upon the broad proposition found in **Birnbaum** that Section 10(b) was not aimed at fraudulent mismanagement of corporate affairs. Clearly, acts can constitute both fraudulent mismanagement and violations of Section 10(b), although those acts originally alleged did not. Nor was **Birnbaum** relied upon for the requirement that one must be an actual purchaser or seller in order to have standing to invoke the protections of the Act. Rather, this Court simply held that the phrase "in connection with the pur-

chase or sale of securities" limits the duties of disclosure imposed by the Act. The article attached to plaintiff's brief, Lowenfels, **The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5**, 54 Va. L. Rev. 268 (1963), is hardly inconsistent with that conclusion. This Court followed the recommendation that it:

> "come immediately to grips with the central problem of most Section 10(b) and Rule 10b-5 cases whether or not the plaintiff has in fact been defrauded **in connection with the purchase or sale of a security.**" *Id.* at 277 (Emphasis added.)

In oral argument on the amended complaint plaintiff has indicated that his theory is not based solely on a failure of disclosure, but rather relies also on the third section of Rule 10b-5, which provides:

> "It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> * * * * * * *
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Apparently plaintiff urges that the phrase "in connection with the purchase or sale of securities" be treated as merely a jurisdictional event, much like the use of the mails, and that sale of control at a premium, when a "fairer" method such as a sale of assets is available, is a fraudulent course of business. Treating the "connection" language as jurisdictional rather than substantive would mean realistically that the dealings with their shareholders of the insiders of every corporation that issues "securities" within the meaning of the Act would be subject to

a full-blown federal common law of fraud. The federal courts have been liberal in developing a law of securities transactions, but the step urged by plaintiff, although arguably desirable, goes considerably beyond any of the cases cited by plaintiff, does not seem authorized by the language and structure of the statute, and is not one this court is willing to take. Even if it were, it is not clear that every sale of control at a premium should be held a fraud on stockholders.

In his amended complaint, plaintiff has added the allegation that defendant Wilder caused National American to pay part of the consideration he received for his sale of control. If supported by the other allegations of the complaint, this would establish the requisite "connection since the corporation would then be, *pro tanto*, a purchaser" of the securities. See **Hooper v. Mountain States Securities Corp.**, 282 F. 2d 195 (5th Cir. 1960); **Ruckle v. Roto American Corp.**, 339 F. 2d 24 (2nd Cir. 1964).

Although the exact details of the transactions by which Wilder is alleged to have received part of his consideration are not clear from the complaint, the essential facts have emerged. Wilder is alleged to have received *inter alia*, from National Securities, Inc., the purchaser of the control bloc, an option to purchase 43,200 shares of certain bank stock. This same bank stock earlier had been the subject of a purchase agreement in favor of First Colonial Corporation (controlled by Wilder, owner of a large bloc of National American stock, also sold to National Securities, and allegedly insolvent), which purchase was guaranteed by National American. It is not alleged how National Securities intended to acquire the asset of its subsidiary (either First Colonial or National American), but the complaint adequately alleges a relationship between the transactions by a conspiracy of the principals to accomplish an overriding purpose.

Viewing the complaint most favorably to plaintiff, it might seem that he has alleged a scheme whereby Wilder profits by exercising the option if the price of the stock increases and whereby National American is the loser if the price of the stock decreases. In any event, it could be said that the credit of National American was extended for the benefit of the defendant. It is not alleged, however, that National American has ever been called upon to fulfill its guarantee. As this Court's previous order made clear, one cannot usually collect damages conditional on an event that has yet to occur. Here, it might be argued that the extension of credit itself caused the damage; but for the guarantee, National American would have been in a position to make other profitable investments. The complaint does not, however, seek damages for this type of loss. Nor does it specifically request declaratory or injunctive relief with respect to the guaranty agreement. This Court concludes that the complaint does not state a cause of action based on this narrow theory of the guaranty agreement—option transaction.

It is manifest from a reading of the complaint as a whole that the purpose of the allegations concerning the guaranty agreement is to resurrect the sale of control theory. Presumably, the contention is that whatever fraud might be found in the guaranty agreement—option transaction somehow "tainted" the entire sale of control. Conceptually, however, the two theories are quite separate, and this Court can find no reason in policy why that distinction should be blurred.

Finally, it should be made clear that even if the complaint were read to state a cause of action based on the narrow theory arising out of the guaranty agreement—option transaction, this Court would not exercise its discretion in favor of exercising pendent jurisdiction over whatever state law claims plaintiff might have arising out of

the sale of control at a premium. Besides being logically and factually distinct, the two claims are of disproportionate size and importance. As the Supreme Court stated in **United Mine Workers v. Gibbs**, 383 U. S. 715, 727:

> "Once it appears that a state claim constitutes the real body of a case, to which the federal claim is only an appendage, the state claim may fairly be dismissed."

In accordance with the foregoing, it is the Order, Judgment and Decree of this Court that defendant Wilder's motion to dismiss be granted and the complaint is hereby dismissed.

The costs of this proceeding are Ordered to be and are hereby taxed against the plaintiff.

Done, this the 14th day of January, 1969.

Frank M. Johnson, Jr.
United States District Judge

APPENDIX IV

In the
United States Court of Appeals
For the Fifth Circuit

No. 27385

Edwin J. Herpich, on Behalf of Himself
and All Other Stockholders, Etc.
Plaintiffs-Appellants

versus

Robert E. Wilder, et al.
Defendants-Appellees

Appeal From the United States District Court for the
Middle District of Alabama

(July 14, 1970)

Before Ainsworth, Dyer and Simpson
Circuit Judges

Ainsworth, Circuit Judge: As in **Herpich v. Wallace,**[1] decided today, we must determine in this case whether minority shareholders of a Louisiana corporation have stated a claim for relief under various sections of the fed-

[1] 5 Cir., 1970, ... F. 2d ... [No. 27729, ...].

eral securities laws[2] so as to entitle them to challenge in federal court, this time in Alabama, the way in which control of their corporation was sold. **Herpich v. Wallace** was directed primarily against the purchasers of control, the so-called Arizona Group. This case is directed against the seller, Robert E. Wilder. The District Court dismissed plaintiffs' complaint against Wilder on the pleadings. With respect to claims under section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C., § 78j(b), and, more particularly, SEC Rule 10b-5, 17 C. F. R., § 240.10b-5, we conclude that the District Court erred. Therefore, for reasons set forth in our opinion in the **Wallace** case, we hold that the judgment appealed from must be reversed in part.[3] The case is remanded for further proceedings not inconsistent with the opinion in **Wallace**, and plaintiffs shall be afforded an opportunity to amend their complaint against Wilder to reflect additional information they say they have obtained since the complaint, as amended, was filed herein.

The principal difference between this case and **Wallace** is that defendants in **Wallace** are the present management of National American Life Insurance Company,

[2] Securities Exchange Act of 1934, § 10(b), 15 U.S.C., § 78j (b), and SEC Rule 10b-5, 17 C. F. R., § 240.10b-5, thereunder; Securities Act of 1933, § 17(a), 15 U. S. C., § 77q(a); Investment Company Act of 1940, 15 U. S. C., § 80a-1 *et seq.*

[3] Count one in this case corresponds to the Investment Act claims aspect of count one in **Wallace**; dismissal of these claims is affirmed. Count two in this case corresponds roughly to the 1933 and 1934 Act claims aspect of count one in **Wallace**; on remand plaintiffs shall be afforded the opportunity to amend count two here to place this case on an even footing with **Wallace**. Count three in this case (the Harris transaction) corresponds to count two in **Wallace** in which a 10b-5 claim is stated. Count four here (the Latta transaction) corresponds to count three in **Wallace**, in which a 10b-5 claim is not stated. Count four in **Wallace** has no counterpart here because plaintiffs do not seek injunctive relief against Wilder individually.

but Wilder, to some extent, has departed the scene. The complaint against Wilder, however, alleges that he has committed overt acts in furtherance of the conspiracy between him and the Arizona Group defendants in **Wallace**. Consequently, having allegedly joined the conspiracy and taken steps to assure its success, Wilder may be held responsible for the acts of his coconspirators in furtherance of their scheme. **Dasho v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262, 267, n. 2; **accord, Shell v. Hensley**, 5 Cir., 1970, ... F. 2d ... [Nos. 27447 and 27514, ...].[4]

On remand, we leave to the determination of the District Court whether any nonfederal claims presented lie within that Court's pendent jurisdiction, and the wisdom of exercising such pendent jurisdiction as is found to exist. **See Kletschka v. Driver**, 2 Cir., 1969, 411 F. 2d 436, 450.

The judgment is Affirmed in part and Reversed in part, and the case is Remanded for further proceedings in accordance with this opinion.

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[4] We have carefully examined the various differences between this case and **Wallace** and have concluded that they are immaterial to the question whether this case must be sent back for the normal process of factual development and a determination of the merits of the case.

APPENDIX V

In the
United States Court of Appeals
for the Fifth Circuit

No. 27729

Edwin J. Herpich, et al.
Plaintiffs-Appellants

versus

Robert H. Wallace, Jack E. Love, et al.
Defendants-Appellees

Appeal from the United States District Court for the Eastern District of Louisiana

(July 14, 1970)

Before Ainsworth, Dyer and Simpson
Circuit Judges

Ainsworth, Circuit Judge: In this case we must determine whether minority shareholders of a Louisiana corporation have stated a claim for relief under various sections of the federal securities laws which entitles them to challenge in federal court, absent diversity, the way in which control of their corporation was sold to an Arizona-based complex of insurance companies. The District Court dismissed their complaint on the pleadings, thus relegating them to the state courts. This appeal requires us to consider basic aspects of the implied right of action for violation of section 10(b) of the Securities Exchange

Act of 1934, 15 U. S. C., § 78j(b), and, more particularly, SEC Rule 10b-5, 17 C. F. R., § 240.10b-5, promulgated thereunder, which right was recognized by this Court in **Reed v. Riddle Airlines**, 5 Cir., 1959, 266 F. 2d 314. The principal issues with which we deal are (1) the standing of plaintiffs to bring this suit under Rule 10b-5 and (2) the extent to which the conduct about which plaintiffs complain is actionable under the rule. In addition, we are asked to recognize various implied rights of action under the Investment Company Act of 1940, 15 U. S. C., § 80a-1 *et seq.*

Plaintiffs are shareholders of National American Life Insurance Company, a Louisiana corporation. Plaintiffs brought this suit on behalf of themselves and similarly situated National American shareholders, and derivatively on behalf of National American. It is a companion to **Herpich v. Wilder**, 5 Cir., 1970, ... F. 2d ... [No. 27385, ...], also decided today by this Court. The principal defendants, referred to as the "Arizona Group," control the present management of National American. Some two or more years ago, the Arizona Group ventured South in search of acquisitions. Following their purchases of control of various insurance companies, among which was National American, they were met with numerous lawsuits challenging their means of acquiring these companies. This action is directed primarily against the purchasers of control of National American. **Herpich v. Wilder**, on the other hand, is directed against the seller of control.

The Arizona Group is comprised of National Securities, Inc. (NSI), Old National Life Insurance Company, Robert H. Wallace, and Jack E. Love, NSI, a Colorado corporation, has its headquarters in Arizona and carries on business through several wholly or partially owned subsidiary or affiliated corporations, including insurance companies. A majority of NSI's stock is owned

by Old National, an Alabama corporation. Old National is said by plaintiffs to be wholly owned by a voting trust of which Wallace and Love are equal beneficiaries. The non-Group defendants here are Luther D. Harris, a director and "controlling person" of National American since 1963, and Raymond A. Latta, who from time to time has served as a consulting actuary to National American.

Plaintiffs' four-count complaint, as amended, alleges violations of section 10(b) of the Exchange Act, Rule 10b-5, section 17(a) of the Securities Act of 1933, 15 U. S. C., § 77q(a), various sections of the Investment Company Act, and applicable state law. Plaintiffs seek damages and injunctive relief where appropriate for themselves and the class of National American share holders they seek to represent, and also on behalf of National American itself. Federal jurisdiction is predicated upon section 27 of the Exchange Act, 15 U. S. C., § 78aa, section 22 of the Securities Act, 15 U. S. C., § 77v, and section 44 of the Investment Company Act, 15 U. S. C., § 80a-43.[1] In the court below, defendants filed motions to dismiss for want of subject-matter jurisdiction and for failure to state a claim upon which relief can be granted. The District Judge granted these motions and plaintiffs appeal.

I

From the amended complaint, sworn affidavits, and attached documents,[2] the following allegedly occurred:

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[1] Plaintiffs also sought to invoke the pendent jurisdiction of the District Court, **see**, *e. g.*, United Mine Workers of America v. Gibbs, 383 U. S. 715, 86 S. Ct. 1130 (1966), and cited 28 U. S. C., § 1337.

[2] After the Court had heard oral argument in this and the related Arizona Group cases decided today, both sides filed supplemental memoranda with the Clerk. Sworn affidavits and attached copies of purported documents were also filed by plaintiffs, who allege that they obtained the information filed as a result of discovery in other Arizona Group cases proceeding in the federal and state courts.

Until January 24, 1968, Robert E. Wilder, who is not a defendant in this case,[3] was the majority shareholder of First Colonial Corporation of America. First Colonial is an "investment company" within the meaning of the Investment Company Act of 1940,[4] but has never complied with the registration and qualifications imposed upon such companies by that act. Wilder owned 55.39 per cent of First Colonial's outstanding common stock. This stock was worthless except for the value of First Colonial's controlling interest in National American. Wilder, as a result of his stockholdings in First Colonial (which owned 26.81 per cent of National American's outstanding common stock), and in National American itself (6.32 per cent of the outstanding common), was in working control of National American. He exercised his power of control over the two corporations as president, director, and chairman of the board of National American and as president and director of First Colonial. This power of control was for sale.

A. The Sale of Control

In late November 1967, Wilder allegedly conspired and agreed with the Arizona Group to defraud National American and the other National American shareholders and to cause National American to transact business with the unregistered investment company that controlled it. Wilder would transfer control of National American to the Arizona Group at a premium price payable to him in part by National American itself. This would be done by causing National American to acquire by indirection some of Wilder's shares of National American and First Colonial stock at a price in excess of the market value of these

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[3] Plaintiffs filed a complaint against Wilder in the Middle District of Alabama. Herpich v. Wilder, M. D. Ala., 1969, Civ. No. 2747-N, **rev'd**, 5 Cir., 1970, ... F. 2d ... [No. 27385, ...].

[4] Investment Company Act of 1940, § 3, 15 U. S. C., § 80a-3.

shares. This result was to be accomplished by means of the following device: NSI would be caused to purchase all of Wilder's shares of National American and First Colonial stock at a price, payable in NSI notes, at least $3,000,000 in excess of the then market value of these shares; the Arizona Group would then cause Alabama National Life Insurance Company, an Alabama corporation they controlled,[5] to replace the notes issued by NSI to Wilder with premium debentures of its own; finally, the Arizona Group would cause a merger into one company of Alabama National, National American, and another Arizona Group corporation. As a further inducement to Wilder, the Arizona Group would cause to be issued to him an option to purchase 54 per cent of the outstanding common stock of Capitol National Bank of Montgomery, Alabama. In return, Wilder would resign his positions at National American and facilitate the election of Wallace and Love and their associates to management positions there.

To carry out their plans, defendants, either as principals or as aiders and abettors, are alleged to have caused the following to be done: NSI and Wilder executed an agreement under which Wilder sold his First Colonial and National American stock to NSI for $5,000,000. This price was $3,000,000 in excess of the then market value of the stock. The Arizona Group paid this premium to acquire control of National American. Control was sought to enable the Arizona Group to loot the corporation and otherwise to waste the corporation's assets to the detriment of the corporation and its shareholders. The Group did not offer to purchase National American stock from plaintiffs or other members of plaintiffs' class on the same terms

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[5] The way in which the Arizona Group acquired Alabama National is being challenged by minority shareholders of that corporation in the Hensley group of cases. *E. g.*, Shell v. Hensley, 5 Cir., 1970, ... F. 2d ... (Nos. 27447 and 27514, Hensley v. Love, N. D. Ala., 1969, 298 F. Supp. 698

given Wilder. Defendants next caused National American and First Colonial to execute an agreement with Federated Investments, Inc. Under this agreement, First Colonial, then insolvent, was to purchase from Federated Investments 43,200 shares of Capitol National Bank of Montgomery stock for $1,188,000. Purchase of these shares, which constituted 54 per cent of the outstanding common stock of the bank, was guaranteed by National American. On or about January 24, 1968, defendants caused NSI to grant Wilder an option to purchase these same shares of bank stock. This option was given as partial payment of the price due Wilder for his First Colonial and National American stock. Because defendants cast the transfer of control of National American as a sale of stock from Wilder to NSI, Wilder realized a premium for passing control of National American's assets which was not made available to or enjoyed by the other shareholders of National American.

B. **The Harris Transaction**

The facts alleged by plaintiffs are as follows: When the Arizona Group acquired control of National American in January 1968, they caused the corporation to continue to honor its obligations under an agreement it made with Harris on February 24, 1967. Under this agreement, National American was to purchase 12,947 shares of First Colonial common stock from Harris, then a National American director, for the excessive price of $100,000. This stock was then worthless. Documents were drawn to indicate that the transaction was a loan by National American to Harris which was secured by a pledge of Harris' stock. The principal amount of the purported loan was to be paid to Harris at the rate of $2,500 a month. In the event Harris defaulted, National American agreed that it would not assert a deficiency against the director regardless of the value of the pledged stock at

the time of the default. The Arizona Group continues to cause the corporation to disburse $2,500 to Harris each month thereby causing the corporation to purchase worth less stock. It does not appear that Harris is in default on the purported loan.

C. The Latta Transaction

Plaintiffs' allegations show the following: On or about April 18, 1967, National American was caused by Latta to arrange the payment of $100,000 to Latta by the device of guaranteeing a "loan" by an unnamed person to Latta in that amount. This purported loan was made to finance Latta's purchase of 20 per cent of the outstanding stock of Dawl Corporation, a Louisiana corporation then owned in part by Wilder. The Dawl stock purchased by Latta was pledged as security for the so called loan. Subsequently, on or about July 1, 1967, Latta exchanged his Dawl stock for First Colonial stock. Although this First Colonial stock is not worth the amount Latta owes on the loan, National American was caused to agree to the substitution of this stock for the Dawl stock as security for the loan. In connection with the $100,000 transaction, National American was caused to agree to pay Latta $45,000 for no consideration whatever to the corporation. It is not alleged that Latta is in default on the loan of $100,000

D. Mismanagement of National American and the Proposed Merger

Since acquiring control of National American, it is alleged that the Arizona Group, aided and abetted by Latta and Harris, have wasted the assets of the corporation. They intend to engage in similar wasting in the future. Moreover, defendants propose to merge National American, Alabama National, and another corporation the Group controls into one company at terms disadvantageous to

National American and the shareholders of National American. Specifically, National American will be caused by the terms of the merger to acquire Wilder's First Colonial and National American stock at the excessive price NSI paid to Wilder for selling control of National American in the first place. To carry out this plan, defendants solicited proxies by mail in September 1968 to elect their nominees to the board of National American. These proxies are said to have been misleading in some manner not pleaded with particularity.

With respect to all wrongs alleged in the complaint, plaintiffs, one of whom was a director of National American, aver that they did not discover the facts they allege until February 14, 1968. Plaintiffs state that they could not have discovered these facts earlier by the exercise of any duty imposed upon them because defendants and those in conspiracy with defendants concealed and misrepresented the facts to prevent National American shareholders from discovering the fraud and deceit being practiced upon them.

All four counts of the amended complaint allege that defendants, either as principals or as aiders and abettors, have in various ways violated section 10(b) of the Securities Exchange Act of 1934 and, more particularly, Rule 10b-5, promulgated thereunder by the Securities and Exchange Commission (SEC).[6] Count one also alleges

[6] Violations of section 17(a) of the Securities Act of 1933, 15 U. S. C. § 77q(a), are also alleged. In this case, however, we need not reach the question whether an implied right of action should be recognized for violations of section 17(a), since section 10(b) of the Exchange Act and Rule 10b-5 thereunder will support as well as would section 17(a) an action for any monetary or injunctive relief to which plaintiffs or their corporation may be entitled. **See,** e. g., Globus v. Law Research Service Inc., 2 Cir., 1969, 418 F. 2d 1276, 1283. **See also** 3 and 6 Loss, Securities Regulation 1778-1791 (2d ed. 1961), 3907-3915 (Supp. to 2d ed. 1969). Consequently, we pretermit discussion of section 17(a) in this opinion.

violations of the Investment Company Act of 1940. The allegations of count one relate primarily to the sale of control by Wilder to the Arizona Group and the means by which this sale was and is being financed. Count two involves the Harris transaction, while count three involves the Latta transaction. Finally, count four, incorporating the allegations of count one by reference, relates primarily to the proposed merger of National American and other Arizona Group corporations into one company. Counts one, two, and three seek damages. Counts two and four seek injunctive relief. Use of the mails is alleged in all counts.

For reasons that follow, we conclude that plaintiffs have stated claims that are triable in the federal courts. Accordingly, without making any suggestion how this case should be determined on the merits, *e. g.*, **Orr v. Thorpe**, 5 Cir., 1970, ... F. 2d ... [No. 27674, June 10]; **Merlite Land, Sea & Sky, Inc. v. Palm Beach Investment Properties, Inc.**, 5 Cir., 1970, ... F. 2d ... [No. 28565, March 19]; **Exhibitors Poster Exchange, Inc. v. National Screen Service Corp.**, 5 Cir., 1970, 421 F. 2d 1313, we reverse in part the judgment of the District Court and remand the case for further proceedings not inconsistent with this opinion.

II

Defendants contend that the "ultimate wisdom" on this case is that the complaint represents an attempt to bring a large state-law derivative action, absent diversity, into federal court on a poor 10b-5 theory.[7] They argue that

[7] Defendants take their contention from a statement made by District Judge Frank M. Johnson, Jr., in the order dismissing plaintiffs' original complaint in the Wilder case [No. 27385]: ". . . [I]t is only fair to note that this Court considers the present complaint an attempt to bring a large state law derivative action, absent diversity, into federal court on a poor 10b-5 theory." Herpich v. Wilder, M. D. Ala., 1968, Civ. No. 2747-N.

plaintiffs lack standing to invoke the private right of action afforded by section 10(b) of the Exchange Act and Rule 10b-5 and that the conduct about which plaintiffs complain is not within the coverage of the section and the rule.

This Court has infrequently had occasion to consider 10b-5 theories, [see n. 4 infra.] Consequently, in determining the questions of standing and coverage presented in this case, we proceed on a relatively unmarked trail. We are, however, not without some guidance, directed as we are by decisions from this and other Circuits and by the "familiar canon of statutory construction that remedial legislation [such as the Exchange Act]" should be construed broadly to effectuate its purposes." **Tcherepnin v. Knight**, 389 U. S. 332, 336, 88 S. Ct. 548, 553 (1967); **Bunn v. Global Marine, Inc.**, 5 Cir., 1970, ... F. 2d ... [No. 28302, June 18].

Section 10 of the Exchange Act, entitled "Regulation of the Use of Manipulative and Deceptive Devices," reads in relevant part as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange
>
> ...

[4] Various aspects of the rule have been considered in the following cases: Rekant v. Desser, 5 Cir., 1970, ... F. 2d ... [No. 25872, April 20]; Kuehnert v. Texstar Corporation, 5 Cir., 1969, 412 F. 2d 700; Lehigh Valley Trust Co. v. Central Nat. Bank of Jacksonville, 5 Cir., 1969, 409 F. 2d 989; Grumbles v. Times Herald Printing Co., 5 Cir., 1968, 387 F. 2d 593; Azalea Meats, Inc. v. Muscat, 5 Cir., 1967, 386 F. 2d 5; Hooper v. Mountain States Securities Corporation, 5 Cir., 1960, 282 F. 2d 195; Reed v. Riddle Airlines, 5 Cir., 1959, 266 F. 2d 314.

[5] Tcherepnin v. Knight, 389 U. S. 332, 336, 88 S. Ct. 548, 553 (1967). **See also** Loomis, **The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940**, 28 Geo. Wash. L. Rev. 214 (1960).

"(b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

By section 10(b) Congress meant to prevent manipulation and control of the prices at which securities are bought and sold and to enable buyers, sellers, and traders of securities to make a proper appraisal of the value of securities. Securities Exchange Act of 1934, § 2(3), 15 U. S. C., § 78b(3). **See also** Hearings on Stock Exchange Regulation Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. (1934); Ruder, **Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?**, 57 Nw. U. L. Rev. 627, 657 (1963)." Thus the section reflects the design of the Exchange Act as a means for preventing inequitable and unfair practices on securities exchanges and over-the-counter markets and for insuring fairness and honesty in securities transactions generally. 48 Stat. 881; **see SEC v. Texas Gulf Sulphur Co.**, 2 Cir., 1968, 401 F. 2d 833, 847-848 (en banc). A fundamental purpose of the Act was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*." **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 186, 84 S. Ct. 275, 280 (1963); **see Tcherepnin v. Knight**, 389 U. S. 332, 336, 88 S. Ct. 548, 553 (1967); **Ansbacher-Siegle, Inc. v. Muscat**, 5 Cir., 1967, 386 F. 2d 5, 8. Congress sought to protect persons "who would be engaged in buying and selling and trading in . . . securities as broadly defined in the Act." **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195, 202.

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[10] This is not to say, however, that section 10(b) is limited to manipulative or deceptive devices employed with respect to the investment value of securities. **See** Hooper v. Mountain States Securities Corp., 5 Cir., 1960, 282 F. 2d 195; A. T. Brod & Co. v. Perlow, 2 Cir., 1967, 375 F. 2d 393.

It did not make section 10(b) self-executing, nor did it limit the section's application to the manipulative and deceptive devices or contrivances known in 1934. Instead, it wrote the section as a "catch all" meant to reach practices employed in connection with the purchase or sale of securities which were contrary to the public interest or the interest of investors. See Hearings on Stock Exchange Regulation Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934)." To the SEC was granted rulemaking authority to define that which Congress made unlawful in section 10(b) namely, the use, in connection with the purchase or sale of securities, of "manipulative or deceptive devices or contrivances."

Rule 10b-5, entitled "Employment of Manipulative and Deceptive Devices," reads as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> "(1) to employ any device, scheme, or artifice to defraud,
>
> "(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(3) to engage in any act, practice, or course of business which operates or would operate as a fraud

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11 "The Administration's spokesman needed only a single sentence to dispose of the somewhat broader version of [§ 10(b)] which was § 9 (c) of the original 1934 bills: 'Subsection (c) says, "Thou shalt not devise any other cunning devices."'" 3 Loss, Securities Regulation 1424 (2d ed. 1961). See also Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 Nw. U. L. Rev. 627 (1963).

or device upon any person, in connection with the purchase or sale of any security."

The SEC adopted Rule 10b-5 in 1942 to close a "loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Sec. Exch. Act Rel. No. 3230 (May 21, 1942). The purpose of the rule, it seems clear, was to afford sellers of securities the same protections already afforded purchasers by the federal scheme of securities regulation. Previously, fraud on sellers, as distinct from fraud on purchasers, see Securities Act of 1933, § 17(a), 15 U. S. C., § 77q(a), was not covered by the securities acts unless committed by an over the counter broker or dealer. 8 SEC Ann. Rep. 10 (1943); see Securities Exchange Act of 1934, § 15(c), 15 U. S. C., § 78o(c). Viewing the rule as an "additional protection to investors," 8 SEC Ann. Rep. 10 (1943), the Commission fashioned it to "make applicable to the purchase of securities, the same broad antifraud provisions which the Congress has imposed in Section 17(a) of the Securities Act of 1933, in connection with the sale of securities." Ward La France Truck Corp., 13 S. E. C. 373, ... n. 8 (1943). To accomplish this end, the Commission simply copied the language of section 17(a) of the Securities Act, with exceptions unimportant in this context, and applied it "in connection with the purchase or sale of any security," this being the reach of section 10(b). See also Birnbaum v. Newport Steel Corp., 2 Cir., 1952, 193 F. 2d 461, 463; 3 and 6 Loss, Securities Regulation 1424-1427 (2d ed. 1961 & 3617 (Supp. 2d ed. 1969).

Together the section and the rule aim at reaching "misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit." Cady, Roberts & Co., 40 S. E. C. 907, ... (1961), carried on "in connection with" the purchase or sale of securities. They are not

intended as a specification of particular acts or practices that constitute "manipulative or deceptive devices or contrivances," but are instead designed to encompass the infinite variety of devices that are alien to the "climate of fair dealing." **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 201, 84 S. Ct. 275, 288 (1963), that Congress sought to create and maintain. **See A. T. Brod & Co. v. Perlow**, 2 Cir., 1967, 375 F. 2d 393, 397; **Cady, Roberts & Co.**, 40 S. E. C. 907 (1961). The operative terms of Rule 10b-5 "fraud," "deceit," "purchase," "sale," and "security," as well as the phrase "in connection with" are infused with special meanings. Their construction, the Supreme Court has admonished, must be broad and flexible so that the remedial purposes of the section and the rule will be effectuated. **Tcherepnin v. Knight**, 389 U. S. 332, 88 S. Ct. 548 (1967); **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 84 S. Ct. 275 (1963). In this area especially, therefore, a case-by-case approach is necessary to the proper development of controlling precedent.

Where, as in this and the other Arizona Group cases decided today, serious questions of public law are presented on pleadings alone, we proceed cautiously, lest we are pulled into academic exercises in a case that factually may never be. **Fred. v. Board of Public Instruction of Dade County, Fla.**, 5 Cir., 1969, 415 F. 2d 851. For purposes of this appeal, the well-pleaded allegations of plaintiffs' amended complaint must be taken as true. **Walker Process Equip. v. Food Mach. & Chem. Corp.**, 382 U. S. 172, 86 S. Ct. 347 (1965); **Cliff Food Stores, Inc. v. Kroger, Inc.**, 5 Cir., 1969, 417 F. 2d 203. Moreover, "[i]n appraising the sufficiency of the complaint we follow, of course, the accepted rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." **Conley v. Gibson**, 355 U. S. 41, 45-46, 78 S. Ct. 99, 102 (1957). **See**

also Barber v. Motor Vessel "Blue Cat", 5 Cir., 1967, 372 F. 2d 926. We turn now to decide the questions of standing and coverage presented.

III

A. Count One

Plaintiffs contend that count one presents three interlocking but separate foundations for private actions under section 10(b) and Rule 10b-5. These foundations are as follows:

(1) National American and its shareholders other than defendants are said to have been defrauded "in connection with" Wilder's sale of securities to the Arizona Group. Because Wilder and the Group defendants cast the sale of control of National American in the form of a sale of Wilder's stock at a premium over market value, Wilder is said to have diverted a corporate opportunity to himself, aided and abetted by the other conspirators, in fraud of the corporation and its other shareholders.

(2) National American and its shareholders other than defendants are said to have been damaged as a result of acts done by defendants in furtherance of their scheme to cause National American indirectly to purchase Wilder's stock in First Colonial and National American. Specifically, it is claimed that defendants agreed as part of their conspiracy that Wilder would transfer control of National American to the Arizona Group for the purpose of enabling the Group to loot the corporation and otherwise to waste its assets. The inducement to Wilder was the premium of $3,000,000 ultimately to be paid by National American itself. As a party to the "plan" to merge National American and Alabama National into one company—thereby causing National American to purchase Wilder's stock at the premium price—National

American is said to be a "purchaser" defrauded "in connection with" its purchase of securities.

(3) As an integral part of the conspiracy between Wilder and the Group, National American was caused to guarantee a promise of First Colonial, then insolvent, to purchase 43,380 shares of Capitol National Bank stock from Federated Investments. Subsequently, NSI granted Wilder an option to purchase the same bank stock. The guarantee by National American is said to constitute a "purchase" "in connection with" which National American has been defrauded.

We consider these three purported bases for a Rule 10b-5 civil action insufficient support for plaintiffs' argument that they are persons entitled to sue on behalf of themselves and their class of National American shareholders for rule violations based upon the allegations of count one. This is not to say, however, that plaintiffs have not stated a 10b-5 claim for relief on behalf of their corporation. As we shall discuss, count one does support a claim for derivative relief on behalf of National American. But on their own behalf, plaintiffs do not claim that they or other members of their class purchased or sold securities in connection with defendants' alleged employment of manipulative or deceptive devices or contrivances; nor do they claim that their damage resulted from their participation in a securities transaction. Therefore, for reasons that follow, we conclude that they are not entitled to bring an action under Rule 10b-5 on behalf of themselves or their class, as distinct from a derivative action on behalf of National American, on the facts alleged in count one.

Private actions (as opposed to SEC actions) brought to enforce liabilities and duties created by the section and the rule have been recognized by this Court since 1959. **Reed v. Riddle Airlines**, 5 Cir., 1959, 266 F. 2d 314. The

private right of action implied under Rule 10b-5 may be invoked on behalf of a corporation in a shareholder's derivative suit. **Bennett v. Breuer**, 3 Cir., 1970, ... F. 2d ... (No. 25872, April 20); see, e. g., **City National Bank of Fort Smith v. Vandeburgh**, 8 Cir., 1970, 422 F. 2d 221; **Camden v. Richardson**, 7 Cir., 1969, 411 F. 2d 489; **Schoenbaum v. Firstbrook**, 2 Cir., 1968, 405 F. 2d 215 (en banc); cf. **Borochia v. Wilson Hotels Corporation**, 383 U. S. 363, 86 S. Ct. 845 (1966); **J. I. Case Company v. Borak**, 377 U. S. 426, 84 S. Ct. 1555 (1964). In **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195, 201, we based our recognition of the private right on the principles set forth in the landmark case of **Kardon v. National Gypsum Co.**, E. D. Pa., 1946, 69 F. Supp. 512. Foremost among these principles is the common law tort doctrine that a person injured by violation of a statute enacted for the benefit of persons in his position may bring his own action seeking redress for the harm caused him. **Kardon v. National Gypsum Co.**, *supra* at 513; see Restatement of Torts, 286 (1938). **See also** Bromberg, Securities Law: Fraud—SEC Rule 10b-5, § 2.4(1)(a) (1967). Supporting this doctrine is the policy undergirding the Exchange Act of providing complete, effective enforcement of the duties and liabilities imposed by the Act. See, e. g., **Ellis v. Carter**, 9 Cir., 1961, 291 F. 2d 270, 274. The SEC deems itself unequipped to make persons whole who have been injured by violations of Rule 10b-5; it seeks only to deter violators of the rule by making violations unprofitable. Brief for the SEC as Amicus Curiae, in **Dolgow v. Anderson**, E. D. N. Y., 1968, 43 F. R. D. 472, 483. Moreover, the Commission has neither the manpower nor the time that completely effective enforcement of the securities laws by it alone would require. Consequently, private actions brought for violations of the rule serve as a "necessary supplement to Commission action." **J. I. Case Company v. Borak**, 377 U. S. 426, 432, 84 S. Ct. 1555,

1380 (1964). As in other contexts, the possibility of monetary damages or injunctive relief in a private action can be a most effective weapon in the enforcement of the antifraud provisions, section 10(b) and Rule 10b-5.

The volume of private litigation under section 10(b) and Rule 10b-5 has increased spectacularly in recent years. With this increase have come an "extraordinary expansion of subject matter coverage" by the section and the rule and the possibility of "extraordinarily great liability" for their violation. **Bisbano v. Donner**, 5 Cir., 1970, ... F. 2d ... [No. 29872, April 20]; **see Mutual Shares Corporation v. Genesco, Inc.**, 2 Cir., 1967, 384 F. 2d 540, 543 n. 6. As the substantive law of Rule 10b-5 develops, a continuing problem confronting the courts concerns the nature of the protection created by the rule, that is, how far should that protection be extended.

In recognizing a private right of action and its corollary, implied civil liability, for violations of Rule 10b-5, courts have a duty to provide such remedies as are necessary to make effective the congressional purpose behind the section and the rule. **J. I. Case Company v. Borak**, 377 U. S. 426, 433, 84 S. Ct. 1555, 1560 (1964); **Sola Electric Co. v. Jefferson Electric Co.**, 317 U. S. 173, 176, 63 S. Ct. 172, 174 (1942). The broad remedial purposes of the Exchange Act suggest that the relief made available should not be limited to a particular type of remedy. **J. I. Case Company v. Borak**, *supra*; **Mutual Shares Corporation v. Genesco, Inc.**, 2 Cir., 1967, 384 F. 2d 540, 547. In the formulation of relief, however, concepts of fairness to those who are expected to govern their conduct under Rule 10b-5 should be considered. Protection for investors is of primary importance, but it must be kept in mind that the nation's welfare depends upon the maintenance of a viable, vigorous business community. Considered alone, the sweeping language of Rule 10b-5 creates an almost completely undefined liability. All that

the rule requires for its violation is that someone "do something bad," Jennings & Marsh, Securities Regulation 961 (2d ed. 1968), in connection with a purchase or sale of securities. Without further delineation, civil liability is formless, and the area of proscribed activity could become so great that the beneficial aspects of the rule would not warrant the prescription. **See Ruder, Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5**, 59 Nw. U. L. Rev. 185, 207-208 (1964). In recognition of this problem, courts have sought to construct workable limits to liability under section 10(b) and Rule 10b-5 which will accommodate the interests of investors, the business community, and the public generally.[12] At the very bold, the problem has been to determine the class of persons who are entitled to bring a private action under the section and the rule. To that problem we now turn.

The standing of a private plaintiff to sue for violations of section 10b-5 and Rule 10b-5 is to be decided, of course, within the framework of Article III of the United States Constitution, which restricts federal judicial power to "cases" and "controversies." **Association of Data**

[12] "Thus, a requirement of privity was at first suggested, see Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S. D. N. Y. 1951), aff'd per curiam, 198 F. 2d 883 (2d Cir. 1952), but has more recently been ignored, e. g., Cochran v. Channing Corp., 211 F. Supp. 239, 243-245 (S. D. N. Y. 1962); see Texas Continental Life Ins. Co. v. Dunne, 307 F. 2d 242 (6th Cir. 1962); Cooper v. North Jersey Trust Co., 226 F. Supp. 972, 978 (S. D. N. Y. 1964)." Mutual Shares Corporation v. Genesco, Inc., 2 Cir., 1967, 384 F. 2d 540, 543, 544 (footnotes omitted). Other limitations have included requirements (1) that the plaintiff actually has relied upon the allegedly fraudulent statement, List v. Fashion Park, Inc., 2 Cir., 1965, 340 F. 2d 457, 462-463, (2) that reliance was reasonable, Rogen v. Ilikon Corporation, 1 Cir., 1966, 361 F. 2d 260, 266-267, (3) that the fraud was the cause in fact of the plaintiff's harm, Barnett v. Anaconda Company, S. D. N. Y., 1965, 239 F. Supp. 766, 776, and (4) that the plaintiff's harm was foreseeable, Vine v. Beneficial Finance Co., 2 Cir., 1967, 374 F. 2d 627, 635.

Processing Service Org., Inc. v. Camp, 397 U. S. 150, 151, 90 S. Ct. 827, 829 (1970). The law of standing has been concerned almost entirely with public law questions such as determinations of constitutionality and review of administrative or other governmental action. Every plaintiff in the federal courts, however, must satisfy the court that he is a proper party to maintain the action he brings — that he has a personal stake in the outcome of the controversy. **See Flast v. Cohen**, 392 U. S. 83, 101, 88 S. Ct. 1942, 1953 (1966); **Baker v. Carr**, 369 U. S. 186, 204, 82 S. Ct. 691, 703 (1962). "The various rules of standing applied by federal courts have not been developed in the abstract. Rather, they have been fashioned with specific reference to the status asserted by the party whose standing is challenged and to the type of question he wishes to have adjudicated." **Flast v. Cohen**, 392 U. S. 83, 101, 88 S. Ct. 1942, 1953 (1968). In the context of a plaintiff seeking to invoke a remedy afforded by section 10(b) of the Exchange Act and Rule 10b-5, "[t]he first question is whether the plaintiff alleges that the challenged [conduct] has caused him injury in fact, economic or otherwise." **Association of Data Processing Service Org., Inc. v. Camp**, 397 U. S. 150, 152, 90 S. Ct. 827, 829 (1970). The second question is whether "the interest sought to be protected by the complainant is arguably within the zone of interests to be protected" by section 10(b) and Rule 10b-5 thereunder, 397 U. S. at 153, 90 S. Ct. at 830. **See also Barlow v. Collins**, 397 U. S. 159, 90 S. Ct. 832 (1970).

When Congress vested federal district courts with exclusive jurisdiction of "all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder," Securities Exchange Act of 1934, § 27, 15 U. S. C., § 78aa, it must necessarily have assumed that this jurisdiction would be invoked only by those showing injury to the type that the Act seeks to prevent. **Cf. SEC v.**

General Time Corp., 2 Cir., 1968, 407 F. 2d 65, 71. Section 10(b) and Rule 10b-5 do not proscribe all fraudulent schemes concocted to take undue advantage of investors, but only those fraudulent schemes that are employed "in connection with the purchase or sale of any security." Congress, when it used the quoted language, did not intend necessarily to require a purchase or sale of securities by the alleged violator as a precondition to the establishment of a violation of the section and the rule, but meant instead to outlaw the employment of manipulative or deceptive devices or contrivances, however novel or atypical they might be, "of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell . . . securities." **SEC v. Texas Gulf Sulphur Co.**, 2 Cir., 1968, 401 F. 2d 833, 860 (en banc). The objectives of section 10(b) are purity of the securities transaction and the securities trading process. Congress was concerned with preventing injury to buyers and sellers of securities, and the basic interest sought to be protected was that of persons engaged in "buying and selling and trading in . . . securities as broadly defined in the Act," **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195, 202, to transact in securities in a "climate of fair dealing." **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 201, 84 S. Ct. 275, 288 (1963); **see Birnbaum v. Newport Steel Corp.**, 2 Cir., 1952, 193 F. 2d 461, 464. In short, Congress meant to afford investors a reasonable opportunity to make knowing, intelligent decisions regarding their purchases and sales of securities in unmanipulated markets, **see Kahan v. Rosenstiel**, 3 Cir., 1970, 424 F. 2d 161, 173, and the loss resulting in connection with purchases or sales without benefit of such an opportunity is the type of injury section 10(b) and Rule 10b-5 seek to prevent. **See Mutual Shares Corporation v. Genesco, Inc.**, 2 Cir., 1967, 384 F. 2d 540, 546. **See also Britt v. Cyril Bath Company**, 6 Cir., 1969, 417 F. 2d 433, 435.

We are of the opinion that only purchasers and sellers of securities involved in an alleged Rule 10b-5 violation that is, securities in connection with which fraud has allegedly been committed can show injury of the type the rule is meant to prevent. The rule was promulgated for their benefit, **see Greater Iowa Corporation v. McLendon**, 8 Cir., 1967, 378 F. 2d 783, and it is they who may invoke the 10b-5 right of action to obtain recompense for economic loss sustained. **See, e. g., Vanderboom v. Sexton**, 8 Cir., 1970, 422 F. 2d 1233; **City National Bank of Fort Smith v. Vanderboom**, 8 Cir., 1970, 422 F. 2d 221; **Iroquois Industries, Inc. v. Syracuse China Corporation**, 2 Cir., 1969, 417 F. 2d 963; **Greenstein v. Paul**, 2 Cir., 1968, 400 F. 2d 580. Those seeking to bring an action for damages sustained as a result of a violation of the rule must show a wrong done to them, that is, an invasion of their own federally protected interest to engage in securities transactions while free from the effects of deceptive or unfair practices employed in connection therewith, not merely a wrong done to someone else. **See Association of Data Processing Service Org., Inc. v. Camp**, 397 U. S. 150, 90 S. Ct. 827 (1970). We conclude, therefore, that for a plaintiff to establish his standing to maintain a Rule 10b-5 action for damages, he must be a purchaser or seller of the securities involved in connection with the alleged rule violation.

We do not say that only those who are purchasers or sellers in the "strict common law traditional sense," **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195, 203, may maintain an action for damages under Rule 10b-5. **See, e. g., Mader v. Armel**, 6 Cir., 1968, 402 F. 2d 158; **Dasho v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262. In deciding whether a plaintiff has standing, we search for what will best accomplish the congressional purpose. **See, Electronic Specialty Co. v. International Controls Corp.**, 2

Cir., 1969, 409 F. 2d 937, 946. Thus we construe the "in connection with the purchase or sale of any security" clause found in both the section and the rule broadly and flexibly to effectuate that purpose. **Tcherepnin v. Knight**, 389 U. S. 332, 88 S. Ct. 548 (1967); **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 84 S. Ct. 275 (1963). The "purchaser" "seller" standing requirement is to be similarly construed, see, *e. g.*, **Mader v. Armel**, 6 Cir., 1968, 402 F. 2d 158; **Vine v. Beneficial Finance Company**, 2 Cir., 1967, 374 F. 2d 627, so that the broad design of the section and the rule is not frustrated by the use of novel or atypical transactions. **Crane Company v. Westinghouse Air Brake Company**, 2 Cir., 1969, 419 F. 2d 737; **A. T. Brod & Co. v. Perlow**, 2 Cir., 1967, 375 F. 2d 393.

Plaintiff's position as shareholders suing derivatively on behalf of National American differs from their position as individuals suing in their own right, for they do allege that National American has purchased securities in connection with the fraud alleged, and the shareholder bringing a derivative action need not personally be a purchaser or seller. *E. g.*, **Rekant v. Desser**, 5 Cir., 1970, ... F. 2d ... [No. 25872, April 20]; **City National Bank of Fort Smith v. Vanderboom**, 8 Cir., 1970, 422 F. 2d 221. Our inquiry consequently extends to whether count one alleges facts amounting to a "purchase" by National American within the meaning of section 16(b) and Rule 10b-5.

Plaintiffs contend that their corporation has standing to invoke the Rule 10b-5 right of action as a result of defendants' scheme to cause a merger into one company of National American, Alabama National, and another Arizona Group corporation on terms disadvantageous to National American. The alleged effect of the merger, when it takes place, will be to cause National American to acquire ownership of Wilder's control stock (both his First Colonial stock and his National American stock) at the

premium price negotiated by the Arizona Group. Notwithstanding that the merger of the corporations has not yet been completed, plaintiffs argue that National American is a statutory "purchaser" entitled to damages under Rule 10b-5 for harmful acts already committed in furtherance of the plan to effect the merger. As authority for their proposition that damages may be awarded under Rule 10b-5 even though the securities transaction giving the plaintiff standing to sue has not been completed, plaintiffs rely upon **Opper v. Hancock Securities Corporation**, 2 Cir., 1966, 367 F. 2d 157, **aff'g.** S. D. N. Y., 1965, 250 F. Supp. 668, and **Goodman v. H. Hentz & Co.**, N. D. Ill., 1967, 265 F. Supp. 440.[13]

In **Opper** a customer sued a brokerage house for damages allegedly resulting from the latter's failure to carry out his order to sell certain securities while the house was disposing of large amounts of similar securities it had held for its own account. The customer eventually sold his securities at a substantial loss. The Second Circuit, in affirming a judgment for the customer, stated, "Failure to carry out the order while disposing of its own similar stock was not only actionable under the contract but also a violation of the Securities Exchange Act." 367 F. 2d at 158. That the Court did not particularize the violation committed makes **Opper** less persuasive than it otherwise might be in this case, since the customer in **Opper** proceeded on the theory that the brokerage house had violated section 15(c)(1) of the Exchange Act, as well as section 10(b). Moreover, even if **Opper** refers to section 10(b), it, like **Stockwell v. Reynolds & Co.**, S. D. N. Y., 1965, 252 F. Supp. 215, 219, appears relevant in the present context only as support for the proposition that section 10(b) and Rule

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[13] Plaintiffs also rely upon Barnett v. United States, 8 Cir., 1963, 319 F. 2d 340. That case, however, came to the Eighth Circuit on petition for review of an SEC order revoking the registration of a company as a broker-dealer and has little, if any, application in the context of private actions.

10b-5 do not require that the plaintiff's purchase or sale immediately follow the defendant's fraud; it is not authority for the propositions that Rule 10b-5 does not require a statutory "purchase" or "sale" and that a private plaintiff need not be a statutory "purchaser" or "seller."

In **Goodman** another customer-broker case, it was alleged that the broker had "sold" the customer nonexistent securities. The District Court upheld the customer's right to sue under Rule 10b-5 over the broker's argument that the Rule requires a completed purchase or sale of securities. 265 F. Supp. at 444. Since there could be no completed transaction, in a common-law sense, in a case involving the purported sale of nonexistent securities, the **Goodman** Court arguably was dispensing with the requirement of a securities transaction by the plaintiff in a Rule 10b-5 action. However, the Court further said that "[P]laintiffs were actual parties to transactions which, for the fraud of [defendant], would have been actual purchases or sales . . ." *Id.* **Goodman**, therefore, rather than dispensing with the necessity of a "purchase" or "sale" of securities by the plaintiff in a Rule 10b-5 action, is consistent with the well-established proposition that a statutory "purchase" or "sale" is not necessarily a technical purchase or sale in common-law parlance. See, *e. g.*, **Mader v. Armel**, 6 Cir., 1968, 402 F. 2d 158; **Dasho v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262; **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195.

Unlike **Opper** and **Goodman**, customer-broker cases involving the sort of frauds associated with trading in the securities markets, count one catalogs a series of acts traditionally dealt with under state law as instances of corporate mismanagement or breaches of fiduciary duties in the corporate context. Plaintiffs seek to link these acts in a chain subject to federal law by their allegation

of an overall scheme to defraud National American in connection with the planned merger of the latter. The broad purpose of this scheme, plaintiffs say, was to transfer control of National American from Wilder to the Arizona Group for a premium payable out of the assets of National American itself.

We begin by recognizing that violators of section 10(b) and Rule 10b-5 are not immunized from civil liability for their unlawful acts merely because these acts were committed as part of a broader scheme of corporate mismanagement. **Rekant v. Desser**, 5 Cir., 1970, ... F. 2d ... [No. 25872, April 20]; see, *e. g.*, **O'Neill v. Maytag**, 2 Cir., 1964, 339 F. 2d 764, 768; **New Park Mining Company v. Cranmer**, S.D.N.Y., 1963, 225 F. Supp. 261, 266. Also, the legality of the entire scheme, under federal and state law, may in certain circumstances be determined by a federal court in an exercise of its pendent jurisdiction. *E. g.*, **Errion v. Connell**, 9 Cir., 1956, 236 F. 2d 447.

State law mismanagement claims cannot be transformed into federal claims under Rule 10b-5, however, merely by means of general conclusionary allegations where one would otherwise not exist. See, **Lester v. Preco Industries, Inc.**, S.D.N.Y., 1965, 282 F. Supp. 459, 462; 6 Loss, Securities Regulation 3631 (Supp. 2d ed. 1969); **cf. Jewell v. City of Covington, Ga.**, 5 Cir., 1970, ... F. 2d ... [No. 28089, April 20]. Section 10(b) is not concerned so much with fraud per se as it is with the effect of fraud upon investors and upon the public interest in the maintenance of free and open securities markets nurtured in a climate of fair dealing. 48 Stat. 881; see, *e. g.*, **Kahan v. Rosenstiel**, 3 Cir., 1970, 424 F. 2d 161, 173; **SEC v. Texas Gulf Sulphur Co.**, 2 Cir., 1968, 401 F. 2d 833, 858-860 (en banc); **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195, 202; **Superintendent of Ins. of St. of N. Y. v. Bankers Life & C. Co.**, S.D.N.Y., 1969, 300 F. Supp. 1083, 1101. Unless the plaintiff has standing to sue

for the rule violation he alleges and states a claim for relief under the rule, he must seek redress for the alleged fraud of the defendants under state law.

To state a Rule 10b-5 claim in a case involving the sort of scheme allegedly employed in this case in violation of the rule, a plaintiff must frame his complaint so that it appears with reasonable clarity therefrom either that a purchase or sale of securities by the plaintiff is the subject of the fraudulent scheme or that the inducement of such a purchase or sale is a purpose of the scheme. That the conduct complained of may be reprehensible does not require the conclusion that a federal remedy must be furnished. **Iroquois Industries, Inc. v. Syracuse China Corporation,** 2 Cir., 1969, 417 F. 2d 963, 969. The rights and remedies provided by the Securities Exchange Act are to serve "in addition to any and all other rights and remedies that may exist at law or in equity . . ." Securities Exchange Act of 1934, § 28(a), 15 U. S. C., § 78bb. If Congress had intended that the federal courts inquire into every decision affecting the management of corporations and then fashion a new federal law superseding state law on the fiduciary responsibilities of corporate directors, officers, and controlling persons, presumably so revolutionary a federal intervention into an area traditionally handled by the states would have been clearly expressed. **See Kaminsky v. Abrams,** S. D. N. Y., 1968, 281 F. Supp. 501, 504-505. **See also** 1 Loss, Securities Regulation 121-129 (2d ed. 1961).

In the present case, plaintiffs allege a broad scheme to defraud National American, involving corporate waste, deprivation of corporate opportunity, and the like, which, plaintiffs say, results or will result in an acquisition of securities by the corporation through a merger. We must ask whether defendants' alleged conduct is the type of fraudulent behavior which was meant to be forbidden by section 10(b) and Rule 10b-5. Affidavits and attached pa-

pers made available to this Court by both sides to the litigation indicate that plaintiffs have grounds upon which to allege that defendants have caused the National American board of directors to resolve that the merger with Alabama National and the other Arizona Group corporation be effected on the disadvantageous terms stated above.[14] The precise question presented, therefore, is whether, on these additional facts, National American is a "purchaser" or "seller" of securities for purposes of the section and the rule.

Under the circumstances of this case, we conclude that the resolution to merge is not unlike a partially consummated contract to buy or sell securities, and that, consequently, the broad antifraud purposes of 10(b) and 10b-5 would be clearly furthered by their application to this situation. **See** Securities Exchange Act of 1934, § 3(a)(13-14), 15 U. S. C. A., § 78c(a)(13-14); **SEC v. National Securities**, 393 U. S. 453, 467, 89 S. Ct. 564, 572 (1969). Shareholders approving a merger have been deemed "purchasers" of securities for purposes of the section and the rule, **SEC v. National Securities**, 393 U. S. 453, 467, 89 S. Ct. 564, 572 (1969), and a merged corporation has been deemed a "purchaser"-"seller." *E. g.*, **Dasbio v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262, 267. In both situations, the persons allegedly injured were required to make decisions regarding the merits of transactions in securities. Here, facts have been adequately alleged upon which it can be contended that the National American board's determination to merge was not such as a reasonable man would make if possessed of all the material information known to the other party to the

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[14] The papers submitted purport to document, among other matters, the agreement, as amended, between Wilder and NSI, the National American board meeting approving the merger plan, other aspects of the merger, and the disposition of Wilder's First Colonial and National American stock since the agreement between Wilder and NSI was first made.

transaction in this instance, the Arizona Group acting through its other corporations. As we have said in the Alabama National case decided today:

> "... When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability. We can make no meaningful distinction between this situation and [one in which] the other party to the securities transaction controls the judgment of all the corporation's board members or conspires with them or the one controlling them to profit mutually at the expense of the corporation, [for] the corporation is no less disabled from availing itself of an informed judgment than if the outsider had simply lied to the board. ..."

Shell v. Hensley, 5 Cir., 1970, ... F. 2d ... [Nos. 27447 and 27514, ...]. In short, we think that where, as here, the defendants control all the corporations to be merged, it is unnecessary to require as a condition precedent to a Rule 10b-5 action for damages by one of the corporations that the merger already be consummated, provided, of course, that the corporation can show that it was directly and proximately injured by the defendants' fraud or deceit in connection with the resolution to merge.

We have said that only purchasers or sellers of securities involved in an alleged Rule 10b-5 violation—that is, securities in connection with which fraud has allegedly been committed—can show injury of the type the rule is meant to prevent. It is they who have suffered legal injury as a result of a rule violation which is compensable

in a private action. Section 28 (a) of the Exchange Act provides that "[N]o person permitted to maintain a suit for damages under the provisions of this [Act] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." 15 U. S. C., § 78bb(a). **Compare** Securities Exchange Act of 1934, § 28(a), 15 U. S. C., § 78bb(a), **with** Clayton Act, § 4, 15 U. S. C., § 15. **See** also **Green v. Wolf Corporation**, 2 Cir., 1968, 406 F. 2d 291, 302-303. The gist of the Rule 10b-5 action for damages is economic injury to the plaintiff resulting proximately from the acts of the defendants which constitute a violation of the rule. **Cf. Winckler & Smith Citrus Products Co. v. Sunkist Growers, Inc.**, 9 Cir., 1965, 346 F. 2d 1012; **Association of Western Railways v. Riss & Company**, D. C. Cir., 1962, 299 F. 2d 133. In this case, plaintiffs allege that defendants have damaged National American in many ways by acts committed to further their overall conspiracy involving the sale of control of National American. Their action is not based merely upon the existence of the conspiracy. SEC Rule 10b-5(1), 17 C. F. R., § 240.10b-5(1), but rests also upon the damage they allege has resulted to National American from those acts of defendants which are found to constitute the employment of manipulative or deceptive devices or contrivances "in connection with" a purchase or sale by the corporation. Such damage is the legal injury to National American which is compensable under the rule. As we have indicated, plaintiffs do have grounds for alleging a statutory "purchase" or "sale" by their corporation. On remand, therefore, it must be determined whether National American, as a "purchaser" or "seller," has been proximately injured by acts amounting to the employment by defendants of a scheme to defraud the corporation in violation of the rule. The question whether the acts complained of in count one constitute a consistent course of conduct carried on to defraud National Amer-

sion in connection with the latter's transaction in securities, and whether this transaction is the subject of all or a part of the overall scheme, goes to the merits of plaintiffs' case, not to the issue whether plaintiffs have stated a claim upon which relief can be granted under section 10(b) and Rule 10b-5. Further proceedings are clearly necessary here.

B. Count Two

The fraud alleged in count two involves National American's purported purchase of worthless First Colonial stock from Harris for $100,000 by the pretext of a loan secured by a pledge of the stock actually purchased. Count two does not allege that the "loan" has been defaulted or that foreclosure on the stock has become necessary. Because such facts are not alleged, defendants argue that count two fails to allege a purchase of securities by National American. The question presented, consequently, is whether count two adequately states facts amounting to a 'purchase' within the meaning of section 10(b) and Rule 10b-5 so as to entitle plaintiffs to maintain a derivative action under the section and rule for damages and injunctive relief on behalf of their corporation.[15]

Given the reading **Conley v. Gibson**, 355 U. S. 41, 78 S. Ct. 99 (1957), requires, count two sufficiently avers, for purposes of withstanding a motion to dismiss made under Fed. R. Civ. P. 12(b), that the pledge agreement was pretextual, disguising a purchase in substance by National American of Harris' worthless stock.[16] Conse-

[15] Plaintiffs have not argued that they have an action in behalf of themselves and their class of National American shareholders on the facts alleged in count two.

[16] The count reads in pertinent part:

"1. On, to-wit, February 24, 1967, National American Life Insurance Company agreed to purchase for One Hundred Thousand Dollars ($100,000) from Luther D. Harris, then one of its directors, Twelve Thousand Nine Hundred Forty-

quently, we conclude that dismissal of count two cannot be sustained on the ground that neither plaintiffs nor their corporation has standing to bring a Rule 10b-5 action on the facts alleged in this count. See, e. g., **City National Bank of Forth Smith v. Vanderboom**, 8 Cir., 1970, 422 F. 2d 221.

Defendants argue that plaintiffs have not stated a claim under Rule 10b-5 because the complaint does not allege facts amounting to a deception of National American which is causally related to a purchase or sale of securities by the corporation. From the complaint, it appears that Harris, a director and "controlling person" of National American, entered into an agreement with the corporation in which the latter agreed to purchase worthless stock from the director. For the reasons we have expressed in **Shell v. Hensley**, 5 Cir., 1970, ... F. 2d ... [Nos. 27447 and 27514, ...], we conclude that dismissal of count two cannot be sustained on the ground that it fails to allege facts amounting to causal deceit. Accordingly, we must send this case back for the normal process of factual development and the determination of the real merits of the dispute. **Merlite Land, Sea & Sky, Inc. v. Palm Beach Investment Properties, Inc.**, 5 Cir., 1970, ... F. 2d ... [No. 28585, March 19].

C. Count Three

Plaintiffs contend that count three sufficiently alleges a fraud on National American in connection with a purchase by it of securities. The allegations from which plaintiffs

> Seven (12,947) shares of the common stock of First Colonial Corporation of America, which were then and are now worth less.
>
> "2. In order to conceal the true nature of said transaction, papers were drawn to indicate that the transaction was a loan. . . ."

Elsewhere in the count it is alleged that the First Colonial stock was "worthless."

claim a securities purchase by National American should be gleaned are as follows: Latta borrowed money from an unnamed person in order to purchase Dawl stock and caused National American to guarantee this loan; Latta then pledged the Dawl stock he had purchased as security for the loan; subsequently, Latta exchanged his Dawl stock for First Colonial stock and caused National American to agree to a substitution of the First Colonial stock for the Dawl stock as security for the loan, even though the First Colonial stock was not worth the amount owed on the loan. Plaintiffs' position, apparently, is that National American, by virtue of its role as the guarantor of the loan to Latta, became a "purchaser" of securities when Latta pledged the stock he bought as collateral for the loan. Plaintiffs base their argument upon the Second Circuit's decision in **SEC v. Guild Films Co.**, 2 Cir., 1960, 279 F. 2d 485.

The **Guild Films** case arose under the Securities Act of 1933. There an individual caused a corporation he controlled to purchase from Guild Films unregistered stock in that company. He purported to take the stock for investment only, and a restriction to this effect was stamped on the certificates. Subsequently, this individual caused the stock to be pledged to certain banks as additional collateral for his already overdue personal notes. Upon his default, the banks attempted to sell the unregistered stock. The SEC then sought to enjoin the sale by the banks. Concluding that the banks were "underwriters" within the meaning of section 2(11) of the Securities Act, the Second Circuit stated:

> "The banks cannot be exempted on the ground that they did not 'purchase' within the meaning of § 2(11). The term, although not defined in the [Securities] Act, should be interpreted in a manner complementary to 'sale' which is defined in § 2(3) as including 'every . . . disposition of . . . a security or interest in a

> security, for value . . . .' In fact, a proposed provision of the Act which expressly exempted sales 'by or for the account of a pledge holder or mortgagee selling or offering for sale or delivery in the ordinary course of business and not for the purpose of avoiding the provisions of the Act, to liquidate a bona fide debt, a security pledged in good faith as collateral for such debt,' was not accepted by Congress."

279 F. 2d at 489 (citations omitted).

Guild Films is factually distinguishable in material respects from the situation alleged in count three. Here, there is no allegation that the loan has been defaulted or that foreclosure on the pledged stock has become necessary. It is not alleged that National Securities has paid anything for the purported interest in Latta's securities it holds. Moreover, it is not alleged that National American was the pledgee; rather, the corporation was the guarantor of the pledgor. Apart from these distinctions, whatever the term "sale" means in section 2(11) of the Securities Act, we are here concerned only with whether the purposes of section 10(b) of the Exchange Act and Rule 10b-5 thereunder would be advanced by their application to the sort of loan guarantee pledge series of transactions presented in this case. Liberally viewed, count three shows that the effect of the fraud alleged is an extension of National American's credit on Latta's behalf. So far as the complaint reveals, this extension was made coincidentally with a stock purchase by Latta. It is not alleged that the corporate decision to make the extension was made in connection with Latta's personal transaction. On these facts, we conclude that defendants' behavior in causing this extension, even if proved to be as alleged, is not the type of fraudulent conduct which was meant to be forbidden by the section and the rule. **See SEC v. National Securities, Inc.**, 393 U. S. 453, 467, 89 S. Ct. 564,

572 (1969). Therefore, National American is not a "purchaser" of securities which is entitled to bring an action under section 10(b) and Rule 10b-5 on the facts alleged in count three.

We leave to the District Court on remand the determinations whether the claims presented in count three are within the court's pendent jurisdiction. **United Mine Workers of America v. Gibbs**, 383 U. S. 715, 86 S. Ct. 1130 (1966); **see Kletschka v. Driver**, 2 Cir., 1969, 411 F. 2d 436, 450, and whether if new facts are brought to light in further proceedings, these facts entitle plaintiffs or their corporation to invoke the private right of action under section 10(b) and Rule 10b-5 for the conduct complained of in this count.

D. **Count Four**

In count four plaintiffs seek to enjoin defendants from consummating the merger of National American with Alabama National and one or more other Arizona Group companies. This merger allegedly will be disadvantageous to National American and its shareholders in that the merger calls for National American, in effect, to pay Wilder the sale-of-control premium negotiated by the Arizona Group and for the present National American shareholders to receive stock in the post-merger corporation which is worth less than their National American stock is worth now. Count four also alleges in conclusionary terms that solicitations misleading in some way not pleaded have been mailed to National American shareholders to obtain proxies supporting the election of Arizona Group nominees to the National American board of directors.

Injunctive relief may be awarded to a private plaintiff under Rule 10b-5 in a proper case. *E. g.*, **Kahan v. Rosenstiel**, 3 Cir., 1970, 424 F. 2d 161; **Britt v. Cyril Bath Com-**

pany, 6 Cir., 1969, 417 F. 2d 433; **Mutual Shares Corporation v. Genesco, Inc.**, 2 Cir., 1967, 384 F. 2d 540. Such relief is available to undo a merger effected in violation of Rule 10b-5. **SEC v. National Securities**, 393 U. S. 453, 89 S. Ct. 564 (1969); **Dasho v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262. No reason is apparent why, under appropriate circumstances, an injunction cannot also be obtained to prevent the completion of a merger that is in the process of being effected in violation of the rule. Under the circumstances of this case, including the information presented to this Court by the parties, we conclude that plaintiffs have stated a 10b-5 claim for relief on behalf of National American in count four. Our conclusion is reached for the reasons we have expressed in regard to the allegations of count one. Whether an injunction would be premature in this case, as defendants suggest, can be determined only after the facts have been developed. Compare **Kohn v. American Metal Climax, Inc.**, E. D. Pa., 1970, ... F. Supp. ... [Civ. No. 70-933, June 8]. Further proceedings are, therefore, necessary. Since the relief plaintiffs seek in count four is obtainable in a derivative action, we do not reach the question whether plaintiffs also have standing in their own right under section 10(b) and Rule 10b-5 to seek this relief.

IV

This Court has not previously had occasion to consider whether a private right of action exists for violations of the Investment Company Act of 1940. 15 U. S. C., § 80a-1 *et seq.* The Second, Third, and Tenth Circuits have recognized such a right. **Brown v. Bullock**, 2 Cir., 1961, 294 F. 2d 415 (en banc); **Taussig v. Wellington Fund, Inc.**, 3 Cir., 1963, 313 F. 2d 472; **Esplin v. Hirschi**, 10 Cir., 1968, 402 F. 2d 94. Only the Eighth Circuit has reached the opposite conclusion. **Brouk v. Managed Funds, Incorporated**, 8 Cir., 1961, 286 F. 2d 901, vacated as moot, 369

U. S. 424, 82 S. Ct. 873 (1962), and that Court has indicated that a different result might obtain in a proper case. **Greater Iowa Corporation v. McLendon**, 8 Cir., 1967, 378 F. 2d 783, 793.

The history of the investment company industry prior to the passage of the Investment Company Act has been well summarized as follows:

> "Born in boom times, weaned upon the 1929 crash, and plagued with a fringe of thoroughly dishonest manipulators, the . . . industry grew without any effective regulation . . . to reap the whirlwind . . . [T]he picture presented by the Securities and Exchange Commission after a four year investigation showed fantastic abuse of trust by management and wholesale victimizing of investment company security holders. In general the abuses stemmed from the control of investment companies by banking, brokerage, or dealer interests a control founded in complicated capital structures, disguised behind meager, and often misleading, reports to stockholders, and exercised to benefit the sponsor without regard to any stewardship on behalf of the investors who put up the money."

Comment, **The Investment Company Act of 1940**, 50 Yale L. J. 440, 441-442 (1941).[17] Determining that the disclo-

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[17] One commentator enumerated some of the abuses as follows:

> ". . .[I]n some instances investment companies were looted by strong-arm tactics involving actual fraud or larceny, and in other cases much the same result was obtained by a widespread employment of most of the known corporate abuses—the formation of companies on 'shoestring' capital; the use of broad charter provisions relative to powers of management and the corporate purpose; the inclusion of exculpatory clauses to shield mismanagement; the failure of sponsors and officers to make capital contributions to some extent, at least, commensurate with their position in the company; perpetuation of control by such persons through proxy solicitations, staggered elections, and

sure treatment of the 1933 and 1934 Acts was insufficient to prevent these abuses, Congress meant by the Investment Company Act to establish a comprehensive scheme for regulating issuers of securities which engage in the business of investing and trading in the securities of others. See 1 Loss, Securities Regulation 144-147 (2d ed. 1961). The technique of the Act is to require registration with the SEC of all investment companies that use the mails or interstate facilities, with registration serving as the handle for the regulatory scheme. Section 7 of the Act imposes the penalty of exclusion from all channels of interstate commerce of investment companies that fail to register in compliance with section 8. 15 U. S. C., §§ 80a-7, 80a-8, and contracts made by unregistered companies are subject to the voiding provisions of section 47(b). 15 U. S. C., § 80a-46(b). The other sections of the Act concern the regulation of registered companies.

In the present case, plaintiffs allege that First Colonial is, and holds itself out to the public as being, an "investment company" within the meaning of section 3 of the Investment Company Act. 15 U. S. C., § 80a-3. They further allege that First Colonial has never complied with the registration provisions of section 8. Count one of the amended complaint avers that National American and its shareholders have been damaged as a result of various transactions that defendants have caused National American to enter into with First Colonial. Specifically, it is alleged that First Colonial was caused by defendants to dominate and control the affairs of National American in violation of section 7(a)(5) of the Act and to transact

seriatim resignations of directors; excessive promotional and managerial expenses; inadequate disclosure of company activities; the failure of dummy directors and others to fulfill their fiduciary duties; and the complexities caused by pyramiding and cross or circular ownership."

Note, **The Investment Company Act of 1940**, 41 Colum. L. Rev. 269, 273-274 (1941).

business with National American in interstate commerce in violation of section 7(a)(4), all to the damage of National American and its shareholders. Plaintiffs, on behalf of themselves and similarly situated National American shareholders and derivatively on behalf of National American, seek to bring an action under the Investment Company Act to enforce the duties and liabilities that act imposes upon defendants.

Defendants argue that the amended complaint fails to state a claim upon which relief can be granted under the Investment Company Act and that, in any event, plaintiffs lack standing to bring an action for the violations about which they complain. More particularly, defendants contend that the Act creates a private right of action only in favor of those who invest in the securities issued by investment companies and that a suit based upon nonregistration can be brought only if the plaintiff's damage is a direct result of the failure to register.

In deciding the question of standing, we assume that First Colonial is an "investment company" and is not exempted from the registration requirements of the Investment Company Act. We also assume, for the purpose of deciding this question, that the Investment Company Act affords a private right of action for injury suffered from its violation to the class of persons whose interest the Act was designed to protect. **Cf. Eastside Church of Christ v. National Plan, Inc.**, 5 Cir., 1968, 391 F. 2d 357, 362; **Goldstein v. Groesbeck**, 2 Cir., 1944, 142 F. 2d 422. We affirm the principle that private actions provide a necessary supplement to SEC action in the enforcement of the Investment Company Act. **J. I. Case Company v. Borak**, 377 U. S. 426, 432, 84 S. Ct. 1555, 1560 (1964). This does not mean, however, that anyone may assume the role of private policeman. Only persons showing injury of the type the Investment Company Act was meant to prevent may be afforded a civil remedy by the Act.

SEC v. General Time Corp., 2 Cir., 1968, 407 F. 2d 65, 71; **Greater Iowa Corporation v. McLendon**, 8 Cir., 1967, 378 F. 2d 783, 793 794. We turn, then, to consider the congressional purpose behind the Investment Company Act of 1940.

Section 1(a) of the Act presents the findings supporting the congressional conclusion that investment companies are affected with a national public interest. 15 U. S. C., § 80a 1(a). Section 1(b) declares that the national public interest and the interest of investors are adversely affected by various practices.[18] The enumerated practices found to have an adverse effect upon the national public interest and the interest of investors fall into the following categories: (1) failure to provide adequate, accurate information to prospective investors and shareholders in investment companies; (2) management of portfolios in the interests of managements and their affiliates rather than in the interests of the shareholders; (3) use of unsound,

[18] Such adverse effects are caused

"(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

"(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

"(3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities;

"(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods

misleading, and unsupervised accounting practices; and (4) changes in the character of the company's business without the consent of the shareholders. Mosley, Jackson, & Barnard, **Federal Regulation of Investment Companies Since 1940**, 63 Harv. L. Rev. 1134, 1140 n. 27 (1950). The purpose of the Act is to eliminate these abuses, 15 U. S. C., § 80a-1(b), through the accomplishment of five basic objectives. These objectives are (1) adequate safeguards for investors in the distribution and sale of investment company securities, (2) honest, unbiased management of investment companies, (3) greater participation in management by holders of investment company securities, (4) creation and maintenance of adequate feasible capital structures of such companies, and (5) transmittal of adequate financial statements and promulgation of uniform accounting rules. **See** 10 SEC Ann. Rep. 162 163 (1944), in 1 Loss, Securities Regulation 149 152 (2d ed. (1961)). The scheme of regulation designed to accomplish the statutory purpose, as indicated above, is pegged upon registration with the SEC of all investment companies doing business in interstate commerce which are not entitled to some exemption.

> of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;
>
> "(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;
>
> "(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;
>
> "(7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or
>
> "(8) when investment companies operate without adequate assets or reserves."

15 U. S. C., § 80a-1(b).

The Investment Company Act was the fifth in a series of federal statutes designed to eliminate certain abuses in the securities industry, abuses that were found to have contributed to the 1929 financial crash and the depression of the 1930's. It was preceded by the Securities Act of 1933, 15 U. S. C., § 77a *et seq.*, the Securities Exchange Act of 1934, 15 U. S. C., § 78a *et seq.*, the Public Utility Holding Company Act of 1935, 15 U. S. C., § 79 *et seq.*, and the Trust Indenture Act of 1939, 15 U. S. C., § 77aaa *et seq.* Like the earlier statutes, the Investment Company Act was meant to provide another step toward a return to the understanding that those who manage other people's money are trustees acting for others. **Cf. SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 186, 84 S. Ct. 275, 280 (1963); S. Rept. No. 47, 73d Cong., 1st Sess. 7 (1933) (presidential message to Congress). From a reading of the "Findings and Declarations of Policy" in section 1, as well as of the substantive provisions of the Act, we think it is clear in light of the circumstances under which the Act was passed that Congress intended to provide a comprehensive regulatory scheme to correct and prevent certain abusive practices in the management of investment companies for the protection of persons who put up money to be invested by such companies on their behalf.

Plaintiffs in the present case do not allege in count one that they or National American hold any ownership interest in First Colonial, the alleged investment company. Plaintiffs' theory is that where an unregistered investment company such as First Colonial dominates another company, in violation of section 7(a)(5) of the Investment Company Act, 15 U. S. C., § 80a-7(a)(5), to the detriment of the dominated company and to the benefit of the unregistered company, a private right of action under the Investment Company Act should be afforded to shareholders of the dominated company. We consider this theory unsound. In relation to First Colonial, plaintiffs

and their class stand as fellow shareholders of National American. In essence, plaintiffs are complaining about the mismanagement of National American which allegedly has been effected by a controlling shareholder (First Colonial). The history and whole pattern of the Investment Company Act convince us that Congress by this statute intended to deter mismanagement of investment companies for the protection of investment company security holders, **see, e. g., Greater Iowa Corporation v. McLendon**, 8 Cir., 1967, 378 F. 2d 783; **Verrey v. Ellsworth**, S. D. N. Y., 1969, 303 F. Supp. 497, not to regulate the management of companies in which investment companies put their funds. The latter purpose may be served by resort to the other federal securities laws, the antitrust laws, and the like. If any legally protected rights of plaintiffs or their corporation have been invaded as a result of an exercise by defendants of First Colonial's controlling interest in National American, plaintiffs must look elsewhere than to the Investment Company Act for a remedy. To be sure, section 7(a)(5) prescribes First Colonial's domination of National American, but plaintiffs have not alleged that, as a result of this violation, they or National American have suffered harm to any interest of theirs which is within the zone of interests protected by the Investment Company Act.[19] Therefore, we

[19] Plaintiffs also seek to bring an action under section 47(b) of the Investment Company Act, 15 U. S. C., § 80a-46(b). The language of section 47(b) establishes that violators and knowing successors in interest are precluded from enforcing contracts made in violation of the Act or any rule thereunder or where performance would involve such a violation. **Cf.** Mills v. Electric Auto-Lite Co., 396 U. S. 375, 90 S. Ct. 616, 623 (1970) (construing section 29(b) of the Exchange Act, an analogue to section 47(b) of the Investment Company Act). In this case, however, plaintiffs have not alleged that there was any contractual relation between National American and defendants herein which was made in violation of any section of the Investment Company Act. Consequently, we do not reach the question whether section 47(b), like section 29(b) of the Ex-

hold that plaintiffs lack standing to bring an action under the Investment Company Act on the facts alleged in count one.

V

We turn finally to defendants' contention that grounds independent of whether the District Court had subject-matter jurisdiction of plaintiffs' claims or whether plaintiffs stated any claims upon which relief can be granted exist for sustaining the judgment below. These grounds are (1) want of indispensable parties and (2) failure of plaintiffs to comply with all requirements for the maintenance of a shareholder's derivative action in federal court. Specifically, defendants argue that the decision below was correct because, under Fed. R. Civ. P. 19, the case could not proceed properly without Wilder and First Colonial as parties and because, under Fed. R. Civ. P. 23.1, plaintiffs did not make a demand for corrective action on the directors and shareholders of National American before bringing this derivative action on National American's behalf. We disagree with defendants' contentions.

The argument that Wilder and First Colonial should be described with the conclusionary term "indispensable parties" is without merit. **See generally Morrison v. New Orleans Public Service, Inc.**, 5 Cir., 1969, 415 F. 2d 419. The relief plaintiffs seek can be accorded from the defendants named in the complaint, these defendants are not left subject to a substantial risk of incurring double, multiple or otherwise inconsistent obligations by reason of the claimed interests of Wilder and First Colonial, and Wilder and First Colonial do not appear to be so situated

change Act. Eastside Church of Christ v. National Plan, Inc., 5 Cir., 1968, 391 F. 2d 357, 362, contemplates private actions for relief by innocent parties to contracts made in violation of the Investment Company Act or performed in violation of the Act.

that disposition of this action might as a practical matter impair or impede their ability to protect the interests defendants claim they have. Fed. R. Civ. P. 19(a). Rule 19, as amended in 1966, was not meant to unsettle the well-established authority to the effect that joint tortfeasors or coconspirators are not persons whose absence from a case will result in dismissal for nonjoinder. Advisory Committee's Note to Rule 19, in 39 F. R. D. 89, 91 (1966). **See also State of Georgia v. Pennsylvania R. Co.**, 324, U. S. 439, 65 S. Ct. 716 (1945); 2 Barron & Holtzoff, Federal Practice and Procedure, § 513.8 (Wright rev. ed. 1961, Supp. 1968).

The argument that plaintiffs have failed to comply with the demand requirements, such as they are, of Rule 23.1 similarly does not justify dismissal of the amended complaint. Rule 23.1 provides that in a shareholder's derivative action, the complaint shall allege "with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and, if necessary, from the shareholders . . . and the reasons for his failure to obtain the action or for not making the effort." Plaintiffs admit that a demand for corrective action was not made upon the National American board of directors or shareholders before this action was commenced, but argue that such demands would have been futile and unavailing. Under the circumstances alleged in the **Conley**-read complaint, we agree with plaintiffs. Accordingly, we conclude that plaintiffs cannot be foreclosed from maintaining this action on the ground that they have not complied with Rule 23.1.

The judgment is Affirmed in part and Reversed in part, and the case is Remanded for further proceedings in accordance with this opinion.

APPENDIX VI

In the
United States Court of Appeals
For the Fifth Circuit

No. 27447

Claude E. Shell
Petitioner-Appellant
versus
Milford E. Hensley
Respondent-Appellee

No. 27514

Jack E. Love, et al.
Petitioners-Appellants
versus
Milford E. Hensley, et al.
Respondents-Appellees

Appeals from the United States District Court for the
Northern District of Alabama

(July 14, 1970)

Before Ainsworth, Dyer and Simpson
Circuit Judges

Ainsworth, Circuit Judge: We must here determine, as in the **Herpich** cases[1] decided today, whether minority

[1] Herpich v. Wallace, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]; Herpich v. Wilder, 5 Cir., 1970, ... F. 2d ... [No. 27385, ...].

shareholders, this time of an Alabama corporation, have stated a claim for relief under various sections of the federal securities laws which entitles them to challenge in federal court, absent diversity, the way in which control of their corporation was sold to an Arizona-based complex of insurance companies. The District Court, deciding that this case should be accorded the normal process of factual development and a determination of the real merits of the case overruled defendants' motions to dismiss the complaint. An important issue with which we deal is the extent to which proof of deception is necessary to show a violation of SEC Rule 10b-5, 17 C. F. R., § 240.10b-5.

These are appeals from interlocutory orders,[2] consolidated by a panel of this Court, which overruled defendants' motions to dismiss the amended complaint filed against them in the court below.[3] Plaintiffs are shareholders of Alabama National Life Insurance Company, an Alabama corporation. They brought suit against Claude E. Shell (appellant in No. 27447), L. E. Cowling, National Securities, Inc. (NSI), Old National Insurance Company, Robert H. Wallace, and Jack E. Love. With the exception of Shell and Cowling, who is not a party to this appeal, defendants are members of the Arizona Group, the principal defendants in **Herpich v. Wallace**, 5 Cir. 1970, ... F. 2d ... [No. 27729, ...] and appellants in No. 27514 herein.

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[2] The District Judge, H. H. Grooms, determined that an immediate appeal from his order overruling defendants' motions to dismiss the complaint might materially advance the ultimate termination of this litigation in light of the decisions in Herpich v. Wilder, M. D. Ala., 1969 [Civ. No. 2747-N, January 14], **rev'd**, 5 Cir., 1970, ... F. 2d ... [No. 27385, ...], and Greenstein v. Paul, 2 Cir., 1968, 400 F. 2d 580. **See** 28 U. S. C., § 1292(b) (1964).

[3] No. 27514, styled "Love v. Hensley," should not be confused with Hensley v. Love, N. D. Ala., 1969, 298 F. Supp. 698, which is yet another of the Arizona Group cases being tried by Judge Grooms.

In the present case, the complaint, as amended, alleged violations of section 10(b) of the Exchange Act,[4] Rule 10b-5,[5] section 17(a) of the Securities Act of 1933,[6] 15 U. S. C.,

[4] Section 10 of the Exchange Act, entitled "Regulation of the Use of Manipulative and Deceptive Devices," reads in relevant part as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange
>
> . . .
>
> "(b) To use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[5] Rule 10b-5, entitled "Employment of Manipulative and Deceptive Devices," reads as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> "(1) to employ any device, scheme, or artifice to defraud,
>
> "(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."

[6] Section 17, entitled "Fraudulent Interstate Transactions," reads in part as follows:

> "(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> "(1) to employ any device, scheme, or artifice to defraud, or
>
> "(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the

§ 77g(a), and applicable state law. Plaintiffs sought damages on behalf of Alabama National, themselves, and all Alabama National shareholders similarly situated. Federal jurisdiction was predicated upon section 27 of the Exchange Act, 15 U. S. C., § 78aa, and section 22 of the Securities Act, 15 U. S. C., § 77v.[7] Defendants filed motions to dismiss for lack of jurisdiction and for failure to state a claim upon which relief can be granted. The District Judge overruled these motions. He did, however, grant defendants' motion to strike the class action allegations from the amended complaint. The present status of the suit, consequently, is that of a derivative action brought on behalf of Alabama National under Fed. R. Civ. P. 23.1.

I

From the complaint, as amended, affidavits, and documents,[8] the facts, as alleged, appear as follows. Over a four-year period, Alabama National was defrauded in various ways by defendants, who acted in several combinations. Two periods of unlawful activity are presented: (1) 1965 until October 1967, during which time Shell and

> statements made, in the light of the circumstances under which they were made, not misleading, or
> "(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

[7] Plaintiffs also sought to invoke the pendent jurisdiction of the District Court, **see**, *e. g.*, United Mine Workers of America v. Gibbs, 383 U. S. 715, 86 S. Ct. 1130 (1966), and cited 28 U. S. C., § 1337.

[8] After the Court had heard oral argument in this and the related Arizona Group cases decided today, both sides filed supplemental memoranda with the Clerk. Sworn affidavits and attached copies of purported documents were also filed by plaintiffs, who allege that they obtained the information filed as a result of discovery in other Arizona Group cases proceeding in the federal and state courts.

Cowling used the funds of Alabama or its subsidiary to finance transactions in securities between themselves, corporations they controlled, or both, for the purpose of enriching themselves at the expense of Alabama National; and (2) October 1967 and thereafter, during which time Shell formulated and carried out his agreement with the Arizona Group to sell control of Alabama National to the latter for a premium payable only to him.

A. 1965-October 1967

It is alleged that in April 1965, Shell, then the president and a director of Alabama National, and Cowling who was responsible for the incorporation and initial capitalization of Alabama National, caused the corporation to loan $432,000 to S & S Development Corporation, which Shell controlled. This loan, for which no security, or grossly inadequate security, was given, was made to finance the purchase by Shell or S & S from Cowling of 862,500 shares of stock in Capital Corporation of Texas. At all pertinent times until control of Alabama National was sold to the Arizona Group, both Shell and Cowling were "controlling persons," as that term is defined in the federal securities acts,[9] of Alabama National. Cowling was also a control

[9] The complaint reads in pertinent part as follows:

"7—at all times relevant, prior to January 16, 1968, defendant Claude E. Shell was president, a director, and a 'controlling person' as defined by the federal securities act of defendant Alabama National Life Insurance Company.

"8—Defendant L. E. Cowling was responsible for the founding and initial capitalization of Alabama National Life Insurance Company, Capital National Life Insurance Company of Houston, Texas, and Southern States Life Insurance Company, and on, to-wit, January 16, 1968 and at all times relevant prior thereto was a 'controlling person' as so defined of Alabama National Life Insurance Company and of Capital Corporation of Texas, which in turn owned enough stock of Alabama National Life Insurance Company to control the latter corporation."

ling person of Capital Corporation, which, in turn, was a controlling person of Alabama National. Capital Corporation held this control position at least partially as a result of its purchase of a substantial block of Alabama National stock from Cowling. Cowling had taken Capital Corporation's note in payment for these shares. In 1967, Bayou Land Corporation, a wholly owned subsidiary of Alabama National, was caused to loan Capital Corporation sums amounting to approximately $267,000 to enable the latter to pay Cowling interest that had accrued on this note. Like the loan from Alabama National to S & S, these advances were not secured by adequate collateral.

B. October 1967 and Thereafter

It is further alleged that during October 1967, Shell, Love, and Wallace conspired and agreed that Shell would sell shares of capital stock in Alabama National and Capital Corporation which were registered either in Shell's name or in the names of corporations he owned to NSI for $1,600,000. This price exceeded the market value of the stock and its cost to Shell, and the excess over market value represented a premium payable only to Shell for transferring control of Alabama National. In furtherance and according to the terms of their scheme, Shell and the Arizona Group caused the following to be done: First, Alabama National was, and is being, required to pay part of the premium going to Shell for selling control of Alabama National. This result was, and is being, accomplished in part through the contrivance of a nine-year employment contract granted by the corporation to Shell. This contract calls for Shell to perform part-time work at a salary of $50,000 a year, which is more than he received when employed as the full-time president of the corporation. In addition, Shell and the Arizona Group caused Alabama National to purchase at excessive prices from NSI certain

savings-and-loan stock, land, and a note secured by a mortgage; these transactions were effected so that NSI could use the money obtained from Alabama National to pay Shell for the sale of control. Secondly, Shell resigned his positions at Alabama National and used his best efforts to obtain the election of Wallace, Love, and Arizona Group designees as officers and directors of the corporation. Thirdly, Shell was not required to account to Alabama National for the payment received from NSI even though, as the conspirators knew, Shell had acquired the stock that NSI bought from him with funds he had borrowed from Alabama National while serving as an officer and director of the corporation. Fourthly, Alabama National was caused to assume certain obligations under a reinsurance agreement at no benefit to Alabama National, but to the benefit of the Arizona Group. Fifthly, defendants sent out misleading proxy materials, reports, and other mailings that served to deceive and lull Alabama National and its shareholders other than defendants. These statements included representations that the $50,000 to be paid Shell each year for nine years was for services rather than consideration for the sale of Shell's stock and omitted to disclose the true value of the savings-and-loan stock, land, and note bought by Alabama National from NSI or that Shell had a duty to account to Alabama National. Finally, defendants caused notices of the 1968 annual shareholders' meeting to be mailed so that they were not received by plaintiffs and their class of Alabama National shareholders until the day of the meeting, August 26, 1968.

Defendants characterize the complaint in this case as being in substance a claim of corporate waste or deprivation of corporate opportunity. They concede that this complaint may give rise to a state-law claim of fraud or breach of fiduciary duty, but contend that it may not be asserted in federal court absent diversity of citizenship between

the parties. First, it is argued, a claim of violations of section 10(b) and Rule 10b-5 is not stated because "causal deceit" is not alleged. Secondly, and in any event, plaintiffs personally and on behalf of Alabama National lack standing to complain of purported violations of the section and the rule.

For reasons that follow, we conclude that the complaint was sufficient to withstand defendants' motions to dismiss for want of jurisdiction and failure to state a claim upon which relief can be granted. Accordingly, without making any suggestion how this case should be determined on the merits, e. g., **Merlite Land, Sea & Sky, Inc. v. Palm Beach Investment Properties, Inc.**, 5 Cir., 1970, ... F. 2d ... [No. 28565, March 19]; **Exhibitors Poster Exchange, Inc. v. National Screen Serv. Corp.**, 5 Cir., 1970, ... F. 2d ... [No. 26643, January 26], we affirm the judgment of the District Court in the appeals numbered 27447 and 27514.

II

The threshold question we must determine is whether plaintiffs have standing to enforce the violations of section 10(b) and Rule 10b-5 which they allege in their complaint.[10] **See Herpich v. Wallace**, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]. We conclude that plaintiffs, as shareholders of Alabama National, may sue the Arizona

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[10] Violations of section 17(a) of the Securities Act of 1933, 15 U. S. C., § 77q(a), are also alleged. In this case, however, we need not reach the question whether an implied right of action should be recognized for violations of section 17(a), since section 10(b) of the Exchange Act and Rule 10b-5 thereunder will support as well as would section 17(a) an action for any monetary or injunctive relief to which plaintiffs or their corporation may be entitled. **See**, *e. g.*, Globus v. Law Research Service, Inc., 2 Cir., 1969, 418 F. 2d 1276, 1283. **See also** 3 and 6 Loss, Securities Regulation 1778-1791 (2d ed. 1961), 3907-3915 (Supp. to 2d ed. 1969). Consequently, we pretermit discussion of section 17(a) in this opinion.

Group and Shell derivatively on behalf of Alabama National under the section and the rule.

The individual right of action implied under Rule 10b-5 may be invoked on behalf of a corporation in a shareholder's derivative suit. **E. g., Herpich v. Wallace**, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]; **Rekant v. Desser**, 5 Cir., 1970, ... F. 2d ... [No. 25872, April 20]; **City National Bank of Fort Smith v. Vanderboom**, 8 Cir., 1970, ... F. 2d ... [Nos. 19550-19554, February 20]; **Condon v. Richardson**, 7 Cir., 1969, 411 F. 2d 489; **Schoenbaum v. Firstbrook**, 2 Cir., 1968, 405 F. 2d 215 (en banc). The shareholder who brings a derivative suit under the rule need not personally be a statutory "purchaser" or "seller". It suffices, for the purpose of establishing standing to sue, that the shareholder allege that his corporation has "purchased" or "sold" securities in connection with some fraudulent activity. **Herpich v. Wallace**, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]; **City National Bank of Fort Smith v. Vanderboom**, 8 Cir., 1970, ... F. 2d ... [Nos. 19550-19554, February 20]; **Surowitz v. Hilton Hotels Corporation**, 7 Cir., 1965, 342 F. 2d 596, 604, **rev'd on other grounds**, 383 U. S. 363, 86 S. Ct. 845 (1966).

The complaint in the present case alleges that Alabama National has been defrauded in connection with its purchase at excessive prices from NSI of, among other things, 219,687 shares of stock in Southwest Savings & Loan Association. In the context of defendants' motions to dismiss the complaint, this allegation, which must be taken as true, **Walker Process Equip. v. Food Mach. & Chem. Corp.**, 332 U. S. 172, 86 S. Ct. 347 (1965); **Cliff Food Stores, Inc. v. Kroger, Inc.**, 5 Cir., 1969, 417 F. 2d 203, suffices to give Alabama National, and its shareholders suing derivatively, standing to bring an action under section 10(b) and Rule 10b-5. **Herpich v. Wallace**, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]; **cf. Tcherepnin v.**

Knight, 389 U. S. 332, 88 S. Ct. 548 (1967); Securities Exchange Act of 1934, ... §§ 3(a)(10), 3(a)(13), 15 U. S. C., §§ 78c(a)(10), 78c(a)(13).[11]

III

The complaint, in addition to declaring that plaintiffs did not discover the wrongs committed by defendants until August 1968, asserts that (1) Alabama National and its shareholders were deceived regarding the true nature of Shell's so-called employment contract, (2) Shell's duty to account to Alabama National was not disclosed in proxy and other mailings, and (3) the true value of the securities and land purchased by Alabama National from NSI was concealed. Defendants contend that the complaint fails to state a cause of action under section 10(b) and Rule 10b-5 because it does not allege facts amounting to "deception" of Alabama National in connection with

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[11] Section 3(a) (10) reads as follows:

> "The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

Section 3(a) (13) reads as follows:

> "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

These definitions apply when the terms "security," "buy," and "purchase" are used in the Exchange Act "unless the context otherwise requires." 15 U. S. C., § 78c(a).

purchases of securities by Alabama National. Plaintiffs respond that deception is adequately alleged and that, in any event, proof of deception is not required in an action brought under sub-sections (1) and (3) of Rule 10b-5. We are thus called upon to consider the extent to which proof of deception must be shown in order to establish a cause of action under the section and the rule. In deciding this case, we are mindful that we venture into an area of law where "glib generalizations and unthinking abstractions are major occupational hazards," **SEC v. National Securities**, 393 U. S. 453, 465, 89 S. Ct. 564, 571 (1969), and a cautious, case-by-case approach is necessary to the proper development of controlling precedent. **Herpich v. Wallace**, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]. Consequently, we inquire herein whether defendants' conduct, if proved to be as plaintiffs allege, is the type of behavior which was meant to be prohibited by the section and the rule. **SEC v. National Securities**, 393 U. S. 453, 467, 89 S. Ct. 564, 572 (1969).

Shell and the Arizona Group argue that plaintiffs have not stated a claim under Rule 10b-5 because the complaint does not allege either (1) that members of the Alabama National board of directors were deceived in any way in connection with the corporation's purchase or sale of securities or (2) that Shell, one member of an eleven man board, or the Group controlled the actions of a majority of the board. Unlike defendants, we find that a Rule 10b-5 claim has been stated. The complaint alleges a conspiracy between the Arizona Group and Shell to defraud Alabama National by causing the corporation directly, and indirectly through its purchase of securities, to provide the inducement to Shell to sell control of Alabama National to the Group. This inducement allegedly was cast in the form of (1) a sham employment contract that Alabama National was caused to enter with Shell and (2)

a purchase by NSI of Shell's Alabama National and Capital Corporation stock representing the power to control Alabama National at a price in excess of the market value of this stock and its cost to Shell. Alabama National allegedly was caused to pay part of this inducement directly to Shell through the device of the long term employment contract. It allegedly was caused to pay part of the inducement indirectly to Shell through the device of its purchase of securities and other property from NSI at excessive prices, followed by NSI's use of the money received from Alabama National to pay Shell for his stock. This behavior on the part of defendants, if proved, is of the sort that section 10(b) and Rule 10b 5 were meant to prevent.

The complaint affords defendants fair notice of what plaintiffs' claim is and the grounds upon which it rests. It does not appear beyond doubt that plaintiffs can prove no set of facts which would entitle their corporation to relief. Consequently, the District Court was correct in overruling defendants' motions to dismiss. **Conley v. Gibson**, 355 U. S. 41, 45-46, 78 S. Ct. 99, 102 (1957); **Cliff Food Stores, Inc. v. Kroger, Inc.**, 5 Cir., 1969, 417 F. 2d 203; **Pred v. Board of Public Instruction of Dade County**, 5 Cir., 1969, 415 F. 2d 851. Fairly read, the complaint alleges that defendants, directly or indirectly, caused at least a majority of the Alabama National board to act adversely to the interests of their corporation in connection with a securities transaction between Alabama National and NSI which was not conducted at arm's length. If proved to be as alleged, defendants' behavior violated section 10(b) and Rule 10b 5. **See Schoenbaum v. Firstbrook**, 2 Cir., 1968, 405 F. 2d 215 (en banc).

As used in the complaint,[12] the term "control" is a shorthand expression of the "power to direct or cause

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[12] **See** note 9, *supra*.

the direction of the management and policies of a person. . . . " SEC Rule 12b 2(f), 17 C. F. R., § 240.12b 2(f). **See also Susquehanna Corp. v. Pan American Sulphur Co.**, 5 Cir., 1970, 423 F. 2d 1075; Berle, **The Price of Power: Sale of Corporate Control**, 50 Cornell L. Q. 628, 630 (1965). Taking the allegations of the complaint as true, we find that Shell possessed "control" of Alabama National until mid January 1968. On January 19, 1968, he executed an agreement to sell his power over Alabama National to NSI and thereafter resigned as an officer and director of Alabama National. Then, on January 25, 1968, Alabama National was caused to purchase securities at an exorbitant price from NSI. NSI, having just acquired control of Alabama National from Shell, then possessed the "power to direct or cause the direction of the management" of its customer. The question whether the transaction between Alabama National and NSI was conducted at arm's length, with the Alabama National board of directors, goes to the merits of plaintiffs' case, not to the jurisdiction of the federal court or the sufficiency of the complaint to withstand a motion to dismiss for failure to state a claim. *

Under the facts alleged, the Arizona Group, acting through NSI, was in a position either to govern the judgment of the Alabama National board or to conspire with Shell to govern the board's judgment in connection with Alabama National's purchase of securities and other property from NSI. Defendants' reliance on the lack of an express allegation that any Alabama National director was deceived in connection with this purchase as a ground for dismissing the complaint is not warranted. To be sure, as a general statement of corporate law, a corporation can acquire knowledge only through its officers and agents and can know only what its officers and agents know. *E. g.*, **Bergeson v. Life Insurance Corporation of America**, 10

Cir., 1959, 265 F. 2d 227, 232; 3 Fletcher, Private Corporations § 790 (perm. ed. 1965); Restatement (Second) of Agency § 9(3) (1958). Arguably, therefore, if the corporation's officers or agents are not deceived, the corporation is not deceived, and a claim is not stated under section 10(b) and Rule 10b-5. **See O'Neill v. Maytag**, 2 Cir., 1964, 339 F. 2d 764. This contention rests upon the idea that the corporation should be treated as possessing the attributes of a person. Like other concepts of the corporate business organization, however, the anthropomorphic concept of the corporation a person capable of injury and knowledge is not a universal solvent for problems involving corporate relationships. **See**, *e. g.*, Andrews, **The Stockholder's right to Equal Opportunity in the Sale of Shares**, 78 Harv. L. Rev. 505, 538-545 (1965). In the present context, our predominant concern is with effectuating the remedial purposes of section 10(b), as implemented by Rule 10b-5. **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 195, 84 S. Ct. 275, 284-285 (1963). Conceptual analysis of corporate relationships must bow to that concern. **See Dasho v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262, 270 (Fairchild, J.); **Ruckle v. Roto American Corporation**, 2 Cir., 1964, 339 F. 2d 24, 29.

Defendants' position, by allowing all liability under section 10(b) and Rule 10b-5 to be foreclosed on the basis of a finding that all the Alabama National directors knew that they were causing their corporation to pay excessive consideration for securities and other property, would remove the corporation—and hence its shareholders—from the protection of the section and the rule merely because of the ease with which defendants victimized it. The result would be to permit those dealing with a corporation to practice the basest sort of chicanery in connection with securities transactions they enter into with that corporation. They would need only to hold sway over the

corporation's directors or cause them by other means to act adversely to the interests of the organization they were charged to manage. In such a situation, the corporation is deprived of the opportunity to engage in securities transactions in a "climate of fair dealing," **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 201, 84 S. Ct. 275, 288 (1963). Vindication of the congressional purpose to establish a climate of fairness for securities transactions is required in these circumstances by the section and the rule. When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability. We can make no meaningful distinction between this situation and the one at hand. When the other party to the securities transaction controls the judgment of all the corporation's board members or conspires with them or the one controlling them to profit mutually at the expense of the corporation, the corporation is no less disabled from availing itself of an informed judgment than if the outsider had simply lied to the board. In both situations the determination of the corporation's choice of action in the transaction in question is not made as a reasonable man would make it if possessed of all the material information known to the other party to the transaction.

Under the particular circumstances of this case, therefore, we conclude that an express allegation that Alabama National directors have been deceived in connection with the corporation's purchase or sale of securities is not a necessary element of a 10b-5 claim asserted on behalf of the corporation. It suffices, for purposes of stating a claim

under Rule 10b-5, that the complaint alleges that Alabama National, as a result of the conspiracy carried out by Shell and the Arizona Group, was caused to participate in a securities transaction in which it was prevented by both the other party and its own directors from taking advantage of the safeguards the disclosure requirements of the rule were meant to provide.[13]

The orders in Nos. 27447 and 27514 are Affirmed.

[13] With respect to Shell, the complaint alleges that this defendant committed acts in furtherance of the conspiracy between him and the Arizona Group. Having allegedly joined in the conspiracy and taken steps to assure its success, Shell may also be held accountable for the acts of his co-conspirators in furtherance of their scheme. Dasbio v. Susquehanna Corporation, 7 Cir., 1967, 380 F. 2d 262, 267, n. 2. Since we have concluded that plaintiffs have stated a 10b-5 claim on behalf of Alabama National, it is not necessary for us to consider other points raised by plaintiffs on this appeal.

APPENDIX VII

In the United States District Court for the
Northern District of Alabama,
Southern Division

Milford E. Hensley, on Behalf of All Stockholders of Alabama National Life Insurance Company, an Alabama Corporation, Plaintiff, vs. Claude E. Shell, et al., Defendants.	Civil Action No. 68-461

Order on Motions to Dismiss

(Filed Oct. 15, 1968)

The Court has heretofore taken under advisement the several motions to dismiss, and has carefully considered the authorities relied on by the parties. The main thrust of defendants' contention is that plaintiffs are not shown to have been sellers of the stock involved. **Birnbaum v. Newport Steel Corporation**, 2 Cir., 193 F. 2d 461, cert. denied 343 U. S. 956, followed in case of **Greenstein v. Paul**, decided by the Second Circuit on August 30, 1968. This action is filed on behalf of all the stockholders, and the Court is of the opinion that under the facts here averred a "seller" within the purview of the Act need not be one who has actually made a sale of his personal stock. **Hooper v. Mountain States Securities Corporation**, 282 F. 2d 195 (5 Cir.), cert. denied 365 U. S. 814; **Ruckle v. Roto American Corporation**, 339 F. 2d 24 (2 Cir.); **Vine**

v. Beneficial Finance Co., 374 F. 2d 627 (2 Cir.); and **Dasho v. Susquehanna Corporation**, 380 F. 2d 262, cert. denied sub nom **Bard v. Dasho**, 88 S. Ct. 480.

In view of the decisions last referred to, and the broad sweep of **J. I. Case Co. v. Borak**, 377 U. S. 426, and **Surowitz v. Hilton Hotels Corporation**, 383 U. S. 363, the Court is unable to say that it appears beyond doubt that plaintiffs can prove no set of facts in support of their claim which would entitle them to relief. **Conley v. Gibson**, 355 U. S. 41, 45. The motions will be considered as directed to the complaint as amended on October 1, 1968.

It is, therefore, Ordered, Adjudged and Decreed that the motions of Claude E. Shell, L. E. Cowling, Jack E. Love, Robert H. Wallace, National Securities, Inc., Old National Life Insurance Company and Alabama National Life Insurance Company, to dismiss, including defendant Cowling's motion to quash, be and each of same is hereby overruled. Defendants are granted thirty days in which to file their answers to the complaint as amended.

Done and Ordered, this the 15th day of October, 1968.

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United States District Judge

APPENDIX VIII

In the United States District Court for the Northern District of Alabama, Southern Division

Milford E. Hensley et al., Plaintiffs		
vs.		Civil Action No. 69-35
Jack E. Love et al., Defendants		

Order

(Filed March 12, 1969)

This matter came on to be heard on various motions filed on behalf of defendant Robert E. Wilder and on behalf of all other defendants in this action, except Claude Shell, L. E. Cowling, R. L. Cowling, R. E. Cowling, Mrs. Strube, and the Cowling Family Trust. After hearing oral argument thereon, and being advised in the premises, the Court hereby Orders, Adjudges and Decrees as follows:

1. The motion of defendant Wilder to dismiss is hereby denied.

2. The motions filed by the other defendants, with the exception of Shell and the Cowlings, to dismiss are based principally upon the argument that deceit is requisite to the maintenance of a Rule 10(b)5 action, and that the complaint fails to allege sufficiently the requisite deceit, under the authority of **O'Neill v. Maytag**, 339 F. 2d 764, 767-68 (2d Cir. 1964), and **Birnbaum v. Newport Steel Corp.**, 193 F. 2d 461, 463-64 (2d Cir. 1952). However, in view of the reach of the decision in **SEC v. Capital Gains Research**

Bureau, Inc., 375 U. S. 180 (1963), construing "fraud or deceit" as employed in the Investment Advisers Act of 1940, and the recent en banc decision of the United States Court of Appeals for the Second Circuit in **Schoenbaum v. Firstbrook**, CCH Fed. Sec. L. Rep., par. 92, 327 (Dec. 30, 1968), the averments in the particular challenged are sufficient. See also, **Ruckle v. Roto American Corp.**, 339 F. 2d 24, 29 (2d Cir. 1964); **Hooper v. Mountain States Sec. Corp.**, 282 F. 2d 195 (5th Cir. 1960), cert denied, 365 U. S. 814 (1961).

3. Defendants' motions to dismiss are each denied and said defendants will answer the complaint within twenty days.

4. The defendants' motions to quash the deposition of Jack E. Love and to abate further proceedings in this cause are each hereby denied.

All other motions filed herein will be heard at the next regular motion docket.

Done and Ordered, this the 12th day of March, 1969.

H. H. Grooms
United States District Judge